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ABSTRACT

One of a series of teaching units designed to introduce secondary school students to the Canadian economy, this handbook contains instructional materials on Canada's role in the world economy. Ten sections contain readings and suggestions for activities related to Canadian trade, tariffs, the Canada-United States automobile pact, Canada-United States free trade, trade policies in the 1980's, balance of payments, the foreign exchange market, capital flows, the Canadian exchange rate, and the international monetary system. Readings are illustrated with charts, graphs, and cartoons. A final section, a teacher's guide, clarifies learning objectives, terms, and suggested activities for each of the student sections. (LP)

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CANADA IN THE INTERNATIONAL ECONOMY

A TEACHING UNIT

BY WILLIAM T. HUNTER

Series Editor TED STAUNTON

The Canada Studies Foundation — La Fondation d'Etudes du Canada

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Preface

Established in 1970 with individual, corporate and governmental support at both provincial and federal levels, the Canada Studies Foundation, currently funded by the Department of the Secretary of State, has actively promoted mutual understanding among the diversity of peoples in Canada. With the conviction that schools can and must provide a knowledge base to help young Canadians become more informed and more active citizens, the Foundation has supported teachers across Canada in the development of books and other learning materials that assist students in one part of Canada to learn more about their fellow Canadians in other parts of our vast country.

This teaching unit is one of a series devoted to 'Understanding Canada's Economy', which has been developed at Trinity College School, Port Hope, Ontario. This Canada Studies Foundation resource centre has been developing curriculum materials in Economics since 1979. The present series contains four secondary school level teaching units. They are *Money, The Banking System and Monetary Policy in Canada, Unemployment and Inflation in Canada, Canada in the International Economy and Women in the Canadian Economy.* The format is a continuation of the activity approach used in the inaugural C.S.F. - T.C.S. publication in 1979, *Canada's Economy. An Activity Approach* (Jennings, William E. *et al.*, O.I.S.E. Press, 1981). The units are meant to introduce students to various topics in the Canadian economy through various types of activities. It is expected that the activities will generate considerable classroom discussion and debate and thus lead to the development of further understanding.

Teachers may wish to use these units to augment existing materials or as self-contained units of two or three weeks in duration. The language level and presentation of concepts has been written for a senior audience, particularly economics students.

The author of this teaching unit is currently a member of the Economics Department at Trent University, Peterborough, Ontario.

Canadian Trade

The trading of goods with other countries has always been very important in the historical development of the Canadian economy. Central to our economic growth has been the exportation of a succession of "staple" products, beginning with codfish and furs, continuing on with squared timbers and wheat, and, more recently, lumber, newsprint, minerals, oil and natural gas.

The extent of this reliance on trade can be measured by comparing the value of goods exported to the value of all goods and services produced in the economy, and in 1981 this ratio was 28.5%. On the other side of the coin, Canadians imported 25.9% of all goods and services consumed. These measures indicate the degree to which the economy relies on trade, or how "open" it is. Canada's economy is usually described as an open economy because of its relatively large reliance on trade, but it is neither the most nor the least open compared with other countries. For example, in Holland the ratios approach 50%, while in the United States they are closer to 5%.

Since the end of World War II, the growth in world trade has exceeded the growth in world output, at least until 1980. This has been true in Canada as well, although Canada's share of world trade has fallen, indicating that its growth in trade has been less rapid than that of the rest of the world. As a consequence of this increase in trade, the proportion of production which is exported has increased along with the proportion of goods consumed which are imported. This has been happening in all countries, including Canada, and reflects the increased interdependence of the world's economies, or the increased degree to which they depend upon one another for economic survival.

In its early history, Canadian trade was centred on England, but with the passage of time, this trade has been increasingly concentrated on the United States. Roughly 70% of our exports go to and our imports come from the Americans, with a drastic decrease in the importance of England as a market, and an increased role for Japan. The Japanese have also increased in importance as suppliers of imports, along with the member countries of the Organization of Petroleum Exporting Countries (OPEC) and the members of the European Economic Commmunity (EEC) other than England.

1 Activity

The following statistics for Canadian merchandise trade for 1981 show the commodity classification for exports and the classification of imports according to their final use. As well, exports and imports are given for various areas.

MERCHANDISE EXPORTS (millions of dollars)

Farm and Fish Products:		
Wheat and wheat flour	$ 3,915	
Barley, oats and rye	949	
Other	4,966	$ 9,830
Forest Products:		
Softwood lumber	2,912	
Wood pulp	3,820	
Newsprint	4,326	
Other	1,796	12,855
Metals and Minerals:		
Iron ore	1,465	
Primary iron and steel	2,390	
Aluminum and products	1,586	
Copper, nickel and products	2,216	
Lead, zinc and products	937	
Crude petroleum and natural gas	6,875	
Uranium ores and concentrates	179	
Other	6,183	21,831
Chemicals and Fertilizers:		4,617
Other Manufactured Goods:		
Motor vehicles and parts	13,538	
Aircraft and parts	1,797	
Other	16,737	32,071
Total Domestic Exports		$ 81,203
Exports of Foreign Products		2,475
TOTAL EXPORTS		$ 83,678

1 Activity

MERCHANDISE IMPORTS: (millions of dollars)

Fuels and Lubricants:		
Petroleum products	$ 8,623	
Other	840	$ 9,462
Industrial Materials:		
Primary Farm	404	
Textiles, Fur and Leather	2,170	
Ores, Primary Metal and Mineral	6,346	
Chemical	3,571	
Other	4,542	17,033
Construction Materials		1,686
Motor Vehicles and Parts:		16,576
Other Transportation Equipment and Parts:		2,979
Producer's Equipment:		
Tractors and Agricultural	2,396	
Power Generation and Transmission	1,695	
Construction, Conveying and Mining	2,650	
Other Special Industry	2,793	
Other equipment	8,253	17,787
Consumer Goods:		
Food	4,520	
Other non-durables and semi-durables	3,847	
Durables	4,202	12,569
Special Items:		1,035
TOTAL IMPORTS		$ 79,129

EXPORTS AND IMPORTS BY AREA:

MERCHANDISE EXPORTS: (millions of dollars)

U.S.A.	$ 55,378
U.K.	3,347
Other EEC	5,628
Other OECD Europe	1,723
Japan	4,522
Other America	4,226
All Other Countries	8,854
	$ 83,678

MERCHANDISE IMPORTS: (millions of dollars)

U.S.A.	$ 54,350
U.K.	2,377
Other EEC	4,117
Other OECD Europe	1,862
Japan	4,038
Other America	5,093
All Other Countries	7,292
	$ 79,129

1 Activity

Notes:

- The present members of the EEC are Germany, France, Italy, Belgium, Luxembourg, Holland, Denmark, Ireland, England and Greece.
- OECD is the Organization for Economic Co-operation and Development and its membership is made up of industrialized countries with market economies. It does not include centrally planned economies such as the Communist countries, and the developing countries. It is sometimes referred to as "the rich man's club". Canada is included in the 24 members. Other OECD Europe would mean industrialized countries of Western Europe which are not members of the EEC, such as Switzerland and Sweden.

Source: Bank of Canada Review, September, 1982 — Tables 72, 74 & 75.

Questions

1. Has Canada a surplus or a deficit in overall trade in merchandise goods?
2. What percentage of both imports and exports were accounted for by each of the major categories of goods?
3. What do the figures show about the balance of trade (exports-imports) in oil and gas? Canada has a surplus in trade in energy products. Can you explain this?
4. What do the figures show about the balance of trade in motor vehicles and parts?
5. What do the figures show about the balance of trade in agricultural products and food?
6. What do the figures show about the balance of trade in merchandise goods for each of the country groupings?

What determines which goods a country exports and which goods it imports? Basically, a country exports goods that it can produce more cheaply than could be done in other countries, and imports those goods which could only be produced at home at greater expense. It is obvious that Canada has an advantage in producing goods that make use of her large supply of natural resources, and this is usually referred to as Canada having an *absolute advantage* in the production of such goods.

However, it is also possible to have a *comparative advantage* in producing certain commodities, which means that trade can benefit both countries even when one of the trading partners is more efficient at producing all goods than the other country. This same principle applies in the everyday world with a lawyer who is better at both legal matters and at typing than a secretary, but who nevertheless hires the secretary to do the typing. The lawyer has an absolute advantage in both law and typing, but the superiority in legal work is even greater than the superiority in typing, and so he/she is said to possess a comparative advantage in law. On the other hand, the secretary's inferiority is less in typing, and he/she is said to have a comparative advantage in typing. By specializing in their areas of comparative advantage they can produce more and both be better off.

Another possible reason for a country having lower costs is the possession of advanced technology which allows it to lead the way in the introduction of certain advanced products. Research and development activities which give rise to such technological advances is thus a cause of trade, and such reasearch and development is concentrated in the large high income countries such as the United States and Japan. The existence of *economies of scale* may also be the cause of competitive advantage. Economies of scale occur when the average costs of production fall as the quantity produced rises. If production is subject to such economies, a country may lower its costs by specializing in the production of a particular good or component part, while buying other products or components from a trading partner who specializes in their production.

Canadian trade has traditionally been based on the export of natural resources and the importation of manufactured products. The natural resources used in producing exports are increasingly of a non-renewable type, such as oil and gas and minerals, as opposed to natural resources which can be renewed like lumber and agricultural land. This traditional pattern has also meant that our exports contain a fairly high component of unskilled labour while our imports contain more skilled labour. This leads some Canadians to be concerned with the effect of trade on the pattern of employment.

The future of Canadian trade holds promise, problems and challenges. The traditional strength of exports based on natural resources is not beyond challenge. We are no longer exporters of oil, and in other primary products we are facing increased competition. For example, new technology has made lower grade nickel deposits more useful, and whereas Canada once accounted for most of the world trade, Canadian firms have moved production to countries such as Indonesia and Guatemala in order to remain competitive. In agriculture, growth in exports is limited not only by our transportation facilities, but by barriers to our exports in other industrialized countries, by low incomes in developing countries and by our role as a residual supplier to Communist countries in the event that their crops fail. In manufactured goods our relatively small effort in research and development has produced few products where Canada has a technological advantage, while our relatively small economy has made it difficult for us to gain an advantage based on economies of scale.

As we have seen, Canada usually has a positive balance on merchandise trade – that is exports of goods are larger than imports of goods. This has been true in every year since 1961 with the exception of 1975, and this positive balance reached a record level of $7.8 billion in 1980. It will set a new record in 1982. However, concentration on the American market, has meant that our exports depend upon a healthy economy in the United States, and in recent years the American economy has shown low rates of growth. More generally, Canadian exports are concentrated on products the demand for which grows only slowly as incomes grow, whereas our imports rise quickly when Canadian incomes grow. This means that the balance of trade is likely to deteriorate when economic growth resumes. Consequently, many people think it is very important for Canada to gain some advantage in the production of manufactured products which will face better demand prospects and employ more skilled labour, and at the same time produce ourselves more of the goods that we presently import.

2 *Activity*

1. If someone says to you that the low-wage countries can produce everything more cheaply than Canada can, and that therefore Canada cannot gain by trading with them, how could you use the principle of comparative advantage to refute the argument?
2. What do the statistics given earlier tell us about the goods in which Canada has an advantage, and those in which it has a disadvantage?
3. Should Canada try to change its area of comparative advantage, and if so, how?

Canadian Tariffs

A tariff is simply a tax put on an imported good which changes the price of that good between the country putting the tariff on and the rest of the world. It can be shown that if markets work well, free trade between countries will produce the largest volume of goods and services for the trading countries. In spite of this theoretical possibility, almost all countries usually restrict trade in some fashion, and the most popular restriction over the years has been the tariff. The most obvious question, then, is why countries impose tariffs if they could be better off without them.

There may be many reasons for imposing a tariff, and the principal justifications have changed over time. One thing a tariff may do is raise revenue for the government, although if it raises the price of imports so high that none are imported, obviously no revenue would be raised. Other reasons for imposing a tariff might be non-economic; for example, a country may wish to preserve a domestic industry so that it could be self-sufficient in the event of war. However, the usual reason for imposing a tariff is to protect the domestic industry which competes with the imported goods. By protecting the industry, tariffs have an effect on the distribution of income in a country. While there might be more of everything under free trade, this does not mean that everybody will necessarily have more of everything, and as long as some people gain and some people lose, some favour free trade and others will not. Moreover, the gains from free trade are spread over a large number of consumers in the form of lower prices, while the losses are concentrated on the small number of people in the business or industry that is hurt by import competition. The losses for individuals in the smaller group may be larger by far than the gains for individuals in the larger group, and consequently the losers may be more vocal and forceful in their opposition to free trade than the winners are in supporting free trade.

A tariff on imports can generally be said to have several distinct effects. It will raise prices to consumers, and the higher prices will reduce the amount demanded and will encourage increased domestic production in the protected industry, whether owners, workers, or both. The tariff not only redistributes income, but it also leads to reduced efficiency in production, since the country uses more resources to produce goods than would be required to produce them elsewhere.

The Canadian tariff was originally imposed mainly to raise revenue, and at the time of Confederation tariff revenue accounted for about two thirds of the government's revenues. However, in 1879 Sir John A. Macdonald instituted the national policy which was based on the

three pillars of railway building, settlement of the West and the protective tariff. This tariff remained in place, subject to fairly minor alterations, until the 1930s, when Canada, along with other countries, raised tariffs in an attempt to foster employment at home. This was self-defeating, since each country in cutting down its imports was cutting down some other country's exports, and thus of that country's ability to purchase the first country's goods. When the futility of such beggar-your-neighbour remedies was realized, countries tried to negotiate reduction in tariffs in the later 1930s. After the war this process of tariff reduction was organized under the General Agreement of Tariffs and Trade (GATT). There have been seven rounds of tariff reductions under GATT, so that the level of tariffs today is much lower than it had been historically. The most recent round of negotiations called the Tokyo Round and the reductions agreed to are to be put into effect between 1980 and 1986. Canada's average level of tariffs at the present time is slightly higher than those of the United States or the European Common Market, and also shows much wider variations in rates between commodities, with many imports not subject to tariffs. After the cuts agreed to in the Tokyo Round are in place in 1986, the average tariff on all goods subject to duty in Canada will be 8.9%, while the average tariff on all imports (some of which pay no duty) will be 6.5%.

3 *Activity*

Tariffs and Shoes:

The tariff on shoes imported into Canada was 25% in 1980, to be reduced to 22.5% by 1986. There is as well a quota which limits the number of shoes imported. The quota is 11.4 million pairs of shoes for the period from November 1982 to November 1983. If the quota reduces the number of shoes imported below the amount that would come into the country without the quota, it makes imported shoes scarcer and raises the prices of shoes in addition to the price rise resulting from the tariff.

1. How much do you think the tariff and quota together raise the price of shoes above the price that there would be with free trade in shoes?
2. Having figured out the rise in prices in question #1, how much do these restrictions on trade cost **you** in an average year?
3. Many of the companies manufacturing shoes are relatively small and many are located in Quebec. If protection were reduced and these companies went out of business, what alternative employment could be found for these workers?
4. Can you name some Canadian firms which manufacture shoes?
5. Roots makes shoes in Canada and exports as much as 75% of its production to other countries where these exports are subject to a tariff and other barriers to trade. Why, in the light of this, do other Canadian companies need protection from imports?

One of the original intentions of the National Policy was to encourage American companies to set up subsidiary operations in Canada, and the protective tariff certainly succeeded in this objective, although the influx of foreign investment has proved a double-edged sword and a source of controversy that we will be discussing in a later section. Another marked effect of the tariff has been to promote the manufacturing industry which is mainly located in the central area of the country. This regional impact explains the resentment which people in the Maritimes and the West feel towards the central region, as they are forced to pay higher prices for Canadian goods compared to what imports would cost if they were not taxed.

The American tariff has worked against the export of Canadian manufactured goods and encouraged the export of Canadian raw materials. This is because raw materials meet low or zero tariffs, processed raw materials or semi-fabricated goods meet somewhat higher rates and final products meet the highest rates. This is what is known as a *"cascaded" tariff structure*, and is typical of most countries including Canada and the United States. Its effect is to promote the movement of raw materials and the further processing of them in the country where the final product is manufactured.

Since Canadian manufactured goods do not have tariff-free access to the United States, Canadian production is designed for the relatively limited market which our sparsely-populated country provides. As we often attempt to produce the whole range of products available in the United States, we frequently produce inefficiently because of short production runs and small factories which fail to reap all the available economies of scale. The protective tariff in Canada allows companies to be relatively inefficient compared with other industrialized countries, and so the relatively inefficient manufacturing sector is a result of both the Canadian and American tariffs.

The Canadian tariff schedule is a complex document with many thousands of classifications of goods, and with different rates for different goods. Moreover, the rates also differ depending upon the country from which the goods originate. Most imports come in under the Most Favoured Nation (MFN) rate, which is the rate extended to all other members of GATT under GATT rules, and to other countries by negotiation. There were also preferential rates for members of the British Commonwealth, but since England joined the European Economic Community, the system of Commonwealth Preference has pretty well disappeared. A new system of Generalized Preferences was set up in 1975 to apply to all developing countries, and there is a final column called General which is applied to those very few countries not otherwise covered.

Complex as the tariff is, it is not the only means by which trade is restricted, and while tariff levels have gone down in recent years the number of non-tariff barriers to trade has gone up. We have already mentioned the use of quotas, or quantitative restrictions, to limit imports of shoes, and imports of clothing are also subject to quotas. Dumping occurs when goods are sold in foreign countries for less than they are sold in the home country where they are produced, and if this occurs and is injuring domestic producers in the importing country, *anti-dumping duties* may be assessed to try to limit such imports. Certain countries may subsidize exports, and if this occurs and causes injury to producers in the importing country, these producers may apply to have *countervailing duties* assessed on such imports to try to offset the effects of the subsidy. Canada has provisions for both anti-dumping and countervailing duties, although Canadians may be more conscious of the latter policy when such duties are imposed on Canadian exports to the United States, as has happened in the case of Michelin tires and is threatened in the case of softwood lumber exports. Health and safety regulations may restrict trade; governments may favour domestic suppliers over foreign ones even though foreign prices are lower; government agencies such as liquor boards may mark up domestic products by less than foreign brands — the list of possible restrictions on trade is almost endless.

The Canada — U.S. Auto Pact

The automobile industry in Canada in the early 1960's illustrated very well some of the effects of the tariff which were outlined in the preceding section. The major firms were subsidiaries of American companies and they produced pretty well the whole range of models made by their parent companies. Since the market for this production was basically limited to Canada, the production runs were short and the companies' costs were high because they were unable to reap economies of large scale production. As well, because many of the components were imported along with the models which were not produced domestically, and exports of cars and parts from Canada were very limited, Canada had a large deficit in its balance of trade in automobiles and parts.

An initial plan to solve some of these problems involved in giving back to the companies the duties that they paid on imported parts to the extent that they increased exports. When this policy was attacked as an unfair export subsidy by American parts manufacturers, the Canadian and American governments negotiated an agreement in 1965 whereby all automobiles and parts for new automobiles would be free of duty in trade between Canada and the United States. Canada was concerned that all production might move to the United States, and so guarantees were extracted from the Canadian firms in order to ensure that they would maintain certain levels of production in Canada. Thus the Auto Pact was born — a kind of free trade arrangement for the automobile sector. But it was an odd kind of free trade inasmuch as only the car manufacturers had the right to bring goods into Canada duty free; this privilege did not extend to consumers.

The immediate effects of the Auto Pact for Canada were beneficial. The number of models produced in Canada was greatly reduced, economies of large scale production were realized and productivity per worker greatly increased. Investment and production in the industry increased, and one estimate suggested that Canadian GNP was 5.3% higher in 1971 than it would have been in the absence of the Auto Pact.

These benefits were distributed among three major groups. Workers in the industry received higher wages in line with their increased productivity, and by the early 1970's were paid wages equal to those of American automobile workers. A problem may have arisen from this for other Canadian industries whose workers also wanted wage parity but where production had not been reorganized in order to achieve productivity comparable to that in the United States. There was some increase in employment, but it was not proportional to the increase in production, since production per worker, or productivity, had increased so greatly. The companies also benefited from the rearrangement in terms of increased profits, and of course were now able to import cars and parts more cheaply since they did not have to pay duty. Finally, consumers shared in the gains, but to a lesser extent. Since there were no duties and productivity in Canada was comparable to that of the United States, it might be expected that prices would be comparable in the two countries, after allowing for differences in the value of the Canadian and American dollar and taxes. Indeed, since much of Canadian production was now exported for sale to the United States the prices of these cars had to be in line with U.S. prices. There was some narrowing of the difference between Canadian and American prices, but the differential did persist, so that Canadian consumers continued to pay somewhat higher prices than did Americans for the same cars, since they were not allowed to import cheaper American cars for themselves.

More than half of the cars produced in Canada were exported, and while imports of components also increased greatly, Canada's balance of trade on cars and car parts improved. Indeed, in 1970 and 1971 Canada recorded a surplus in such trade. However, the traditional deficit reappeared thereafter as the deficit on parts usually outweighed the surplus on finished automobiles. In any given year the balance reflects the state of the two economies and how many cars and what models consumers are buying. Canada may once again have a surplus in 1982 as indicated in the following new story from the *Globe and Mail Report on Business* for September 15, 1982.

4 *Activity*

Trade surplus sets a record

OTTAWA (CP) — Canada enjoyed a record $1.1-billion automotive trade surplus with the United States in the first half of the year, Statistics Canada says.

The dramatic turnaround from a $1.6-billion deficit in the first half of last year was credited to an increase in the trade surplus on cars, trucks and other vehicles to about $3.9-billion. The surplus was recorded despite a $250-million increase in the deficit on auto parts trade to $2.9-billion.

The country also posted a $94-million surplus on trade in tires and tubes with the United States.

Relatively stable gasoline prices are credited with helping to increase auto trade with the United States, as they have contributed to an increased demand for larger cars, many of which are manufactured in Canada.

On the other hand, the country's automotive trade deficit with the rest of the world was up marginally to $360-million.

In total, the volume of car imports declined 29 per cent, or by 122,000, in the first half of the year, Statscan said.

The decline was primarily the result of a drop in imports from the United States and, to a lesser extent, Japan.

Under an agreement with Tokyo, Japanese car imports this year will be reduced by almost 25 per cent from the 174,000 imported in 1981.

Car imports from France, on the other hand, enjoyed renewed popularity in the first half of the year, increasing by 76 per cent to 9,000.

Question

1. What was the balance of trade in vehicles for the first half of 1982?
2. What was the balance of trade in auto parts for the first half of 1982?
3. What was the overall balance of trade in automotive parts for the first half of 1982?
4. What accounts for the improvement in the trade picture from the Canadian point of view?
5. Do you think the improvement will continue in future years?

The Canada - U.S. Auto Pact

In recent years there has been increased questioning of the benefits of the Auto Pact. Canadian production has tended to concentrate on assembly operations, and assembly operations require less skilled labour and less research and development than parts production. Research and development is located at the American head offices of the car manufacturers, where design and parts sourcing decisions are also made. Canadian production is dependent to a large extent upon the health of the American car market, and when this market is sick the automotive industry in Canada suffers. If a particular model of car is made in more than one location in Canada and the United States, decisions as to where increases or decreases in production are to take place can obviously affect Canada's balance of payments and employment, and such decisions may be subject to political pressure. The Canadian industry may never have had much independence from the American one, but it has even less under the Auto Pact.

The really major change in recent years, however, has been the relative decline of the whole North American car industry, particularly in relation to Japanese firms. Higher oil prices have lead to a demand for smaller more fuel-efficient cars, and Japanese workers have greater productivity and lower wages which make it difficult for North American firms — Canadian or American — to compete. Moreover, Japanese cars have a reputation for being more reliable and cheaper to maintain. If Canadian production is tied to the design decisions of American companies, are we backing the wrong horseless carriage? Imports from Japan are subject to a tariff, equal to 15% at the start of 1980 but scheduled to decline to 6.5% by 1986, and are further limited by voluntary agreements on the part of Japan to limit the number of cars exported to Canada. In 1982 the Canadian government took the unprecedented step of delaying Japanese car imports by tougher customs inspections, in this way putting pressure on the Japanese to agree to a further restriction in imports, as reported in the clipping on the preceding page. In spite of these barriers, Japanese cars take about one quarter of the Canadian market. Are Canadian consumers not being hurt by measures which raise the prices of the increasingly attractive Japanese cars compared to the prices of imports from the United States?

These more recent developments are putting pressure on the Auto Pact and on Canadian policy with respect to the automotive industry. The Americans periodically press to have the Auto Pact renegotiated to eliminate the production safeguards applying to Canadian companies, to allow Canadian consumers to import cars duty free, and to include replacement parts in the free trade agreement as well as parts for new cars. Canadian officials are reluctant to accede to these requests, and find it difficult to attract investment in new production facilities to Canada

in competition against the attraction of such areas as the American Southwest. Canadian governments have offered low interest loans and grants to get investment into Canada; they have helped to bale out Chrysler and they have agreed to let Volkswagen import cars duty free if they manufacture parts in Canada for export to their American assembly operations. They are being pressed to do more, such as requiring a certain Canadian content in any cars sold in Canada. Given the very central position of automobile manufacturing in the Canadian industrial structure, these measures designed to preserve and, if possible, increase employment in Canada are understandable. However, it is also possible to argue that we are mistakenly trying to preserve an industry in decline and that consumers are ultimately footing the bill for this. A sample of this point of view is given in the following article from the *Globe and Mail Report on Business,* October 27, 1982.

21st YEAR, No. 4,821 WEDNESDAY, OCTOBER 27, 1982

Study advises windup of auto industry

By DAVID STEWART-PATTERSON and THOMAS WALKOM
Globe and Mail Reporters

OTTAWA — The Canadian automobile industry is in such bad shape the federal Government should wind up the industry and retrain auto workers for other jobs, says a study prepared for the Canadian Institute for Economic Policy.

The study says Canadian auto makers have no hope of ever competing with the Japanese industry, and the only real question is whether the government should make the cut quickly or ease the industry into retirement.

If the plan is followed, between 32,000 and 58,500 jobs in Ontario alone would disappear in the next five years in automobile producing, related manufacturing and service industries, said Ross Perry, who wrote the report.

Spokesmen for the auto makers withheld their comments on the study, titled The Future of Canada's Auto Industry, but the reaction from union and other representatives was swift.

The report was branded as "absolute nonsense" and lacking economic sense by Robert White, Canadian director of the United Auto Workers union. Patrick Lavelle, president of the Automotive Parts Manufacturers Association of Canada, said that while the report presents a good picture of the industry, its analysis and recommendations are simplistic.

Mr. Perry is an economist with Singer and Associates of Toronto, a member company of Currie Coopers and Lybrand. That is the same company that recently wrote a report for the Canadian Association of Japanese Automobile Dealers. That study sought to prove that protectionist measures such as import quotas on Japanese cars are counter-productive.

He dismissed protectionist policies as a defence against the Japanese because they can be easily circumvented through joint ventures or assembly plants based on parts and technology from Japan. They can be costly to the consumer and result in retaliatory measures against crucial Canadian exports.

But the study makes no attempt to compare the economic costs of protectionism with those of the rapid and massive restructuring of the industry that Mr. Perry said he personally prefers.

This free trade emphasis gets in the way of other possible solutions raised in the report, which suggests, for instance, that Canada could specialize in auto parts with a high energy content.

But the report then says Canada will not likely see the necessary investment in such industries as aluminum die-casting because other countries such as Brazil and Australia are competing for the same Japanese and European capital investment and they have local content requirements to use as a lever.

When asked about this apparently effective use of protectionism by competitors, Mr. Perry said such investment was not all that important because it is capital-intensive and would not create that many jobs.

The report leaves another crucial question unanswered. It calls for large-scale infusions of government money for retraining but gives no indication where tens of thousands of displaced workers would go in an economy that already has problems retraining and finding places for others laid off from declining industries.

The success of Mr. Perry's plans for this massive shift of manpower would depend on heavy government support for former auto workers while they are trained for new jobs and a level of job creation in Ontario equal to that of the late 1970s — about 98,000 new jobs a year.

A rapid rationalization would result in a much leaner and more competitive industry, he said, but there is no guarantee that it could match the Japanese anyway.

Mr. Perry estimated that for the Canadian industry to bridge the $1,100 to $1,200 cost gap between it and the Japanese, there would have to be a 38 per cent reduction in wage levels and a 63 per cent drop in the amount of labor going into each car.

There were about 67,500 wage-earners directly employed in the Canadian auto industry in 1981 and about 54,000 others whose jobs depend indirectly on it, the report said.

The study also said U.S. automobile companies are "disinvesting" in Canada as part of a new strategy that involves more manufacturing outside North America. It cited unpublished U.S. government figures showing that between 1976 and 1980, dividend and interest payments from Canadian affiliates in the transportation industry to U.S. parent companies exceeded capital inflows and retained earnings by $1-billion.

Although it made no formal recommendations, the report implied that the Government should not fight the death of the auto industry but should help workers readjust.

5 *Activity*

1. Has anyone in your family recently bought a car? What kind of car did they buy, and why?

2. Do you know anyone who works for one of the car companies or parts producers in Canada? If their companies were forced out of business what alternative employment opportunities would they have?

3. As we have already seen, Canada exports more goods to Japan than she imports from Japan. However, the exports are almost entirely primary products while the imports are manufactured goods. If Canada restricts imports of Japanese cars, will Japan buy fewer Canadian goods?

4. There are bumper stickers which say, "Buy Canadian cars — the job you have may be your own!" What do you think about this?

5. Should Canadian auto workers make concessions on wages and other benefits as the workers in the United States have done?

6. Should Canada get out of the Auto Pact, nationalize the car companies and produce one model especially designed for Canada?

Canada - U.S. Free Trade

The question of free trade between Canada and the United States, or reciprocity as it used to be known, has been an issue in Canadian economic policy and policies since before Confederation. Indeed, the only time that such a regime was in existence was in the ten year period beginning in 1854. This agreement, which largely concerned trade in primary products, was terminated by the Americans before Confederation. Reciprocity was an issue in at least two subsequent elections, in 1891 and 1911, and in both cases the Liberals who were advocating free trade lost the elections. It has become known in recent years that the issue of free trade with the United States arose in private discussions between the two governments after World War II, but the government, perhaps with an eye to previous history, did nothing about pursuing the possibility.

Tariffs have declined greatly since the war under the bargaining which has taken place in the General Agreement on Tariffs and Trade (GATT). After the latest round of reductions are in place by January 1, 1987, 80% of current Canadian industrial exports will enter the U.S. tariff-free, and 95% will be subject to tariffs of 5% or less. 65% of current U.S. industrial exports will enter Canada tariff-free, and 91% will be subject to tariffs of 5% or less. There are few, if any, tariffs on primary products, and none on some processed products like newsprint. There is a Defence Sharing Agreement between Canada and the United States whereby there is free trade in defense products. Canada imports finished goods like fighter planes but exports specialized component parts for defense products, such as tail assemblies. In the agricultural machinery industry there has been substantially free trade between Canada and the United States since 1944.

Activity

We have seen that there were economic benefits, but also costs, from the limited free trade agreement in cars and car parts that was instituted in 1965. One undeniable fact, however, is that access to a larger market and the specialization that followed from this led to improved productivity and efficiency. There has been free trade in agricultural machinery since 1944, but here the gap in productivity has not been closed. One study shows output per unit of labour as 13-22% less than in the United States in 1973-4.

Questions

1. Why do you think productivity in the Canadian agricultural industry has remained below that in the United States?

2. Can you name a multinational farm machinery company that is based in Canada?

3. Where does that company buy its inputs, where does it assemble its products and where does it sell them?

4. How is that company doing financially?

5. What are the other major companies in the industry and how are they faring?

It has been argued that access to a wider market would put Canada on the same footing as other industrialized countries which either have a large market of their own, such as the United States and Japan, or access to the markets of other countries through some kind of free trade agreement, such as members of the European Economic Community. In 1967, Ronald and Paul Wonnacott estimated the benefit to Canada of eliminating both Canadian and U.S. tariffs at 10.5% of Gross National Product. This estimate was reduced to 8.2% of GNP in a 1975 revision, reflecting mainly the gains that had already been cashed as a result of the Car Pact and the reduction of tariffs under the Kennedy Round of GATT negotiations. In 1975, the Economic Council of Canada in *Looking Outward: A New Trade Policy for Canada* said:

Multilateral free trade would provide the most remarkable improvement in the economic well-being of Canadians that could result from a single step by the government today — or at any time since the Great Depression.

In a 1978 report on Canada's Trade Relations with the United States, the Standing Senate Committee on Foreign Affairs recommended that Canada seriously consider the option of bilateral free trade with the United States, a position that they reaffirmed in 1982.

In the face of views like these, why have Canadian politicians not pushed for free trade between Canada and the United States? Is it just the memory of elections more than seventy years in the past? A more likely answer is that opposition is based on the feeling that further economic integration would lead to even less independence for Canada, and as well would impose serious hardships on particular regions or industries in Canada. Even the Economic Council of Canada felt that in the short run foreign investment in Canada would be increased in the event of free trade as Canadian companies would be taken over by American firms who were already established in the bigger market. Many fear that Canada would have trouble competing for new plants, since firms would want to locate in the larger part of the market in case the agreement were terminated. Still others think that existing plants in Canada would be closed down and the Canadian market served from U.S. companies in the absence of production guarantees. Such guarantees might be hard to extract from the Americans after what they regard as the unfavourable experience with the Car Pact. Some critics of Canada-U.S. free trade wonder whether Canada should tie its economic star to a country which has experienced lower growth than the other industrialized countries, and whether we should concentrate on exporting products which are experiencing low rates of growth in demand.

We have seen that tariffs are already pretty low and scheduled to be even lower in the future. Free trade with the United States would also have to involve removal of non-tariff barriers, if it were really to be effective. An example of such a non-tariff barrier might be countervailing duties. If the government of one country subsidizes its exports, companies in the importing country may feel that they are subject to unfair competition and may request relief from their government. If the government in the importing country finds that the exports have in fact been subsidized and that imports of these goods have caused injury to domestic industries, then they may order the imposition of countervailing duties. The American government imposed such duties on exports of Michelin tires from Nova Scotia, and are threatening to do the same on exports of softwood lumber from Canada. A similar course of action can be followed if dumping takes place, and dumping occurs when goods are sold for a lower price in the importing country than they are sold for in the country where they are produced. Canadian subsidiaries of the American automobile manufacturers were subjected to investigation on charges of dumping cars in the United States at less than prices charged in Canada. We have already seen that they may well have been guilty of this, although nothing ever came of it. Recently the United States has taken a complaint to GATT regarding the demands which the Canadian government has made of American firms wishing to invest in Canada under the terms of the Foreign Investment Review Act, because they believe that trade is affected by guarantees extracted concerning how much the firm exports and where it buys its inputs.

Even if Canadians decide that it would be in their interest to negotiate a free trade agreement with the United States, we cannot assume that this is entirely dependent upon what Canada wants. The United States already has a large market of its own which is free of trade restrictions. Enlarging this market by roughly 10% may not make much difference to the efficiency of American production, or bring about much of a lowering of American prices. Since they may not stand to gain much from free trade, they might only agree to such a plan if they got, for example, guaranteed access to Canada's resources, including water. To assume that Canada-U.S. free trade is entirely a matter of Canadian initiative would be a mistake.

7 Activity

1. What provinces do you think would favour Canada-U.S. free trade, and which would oppose it. Why?

2. If Quebec achieved sovereignty association with the rest of Canada, the PQ want to retain the present arrangement of tariff free access to the rest of Canada but tariff protection with respect to outside countries. Why do they wish to do this? If free trade with Canada makes sense for Quebec, does free trade with the United States not make sense for Canada?

3. Can you think of any barriers to trade within Canada?

4. Do you think the United States would agree to free trade with Canada, and what conditions would the Americans likely want to put on such an agreement?

TRADE POLICY IN THE 1980s

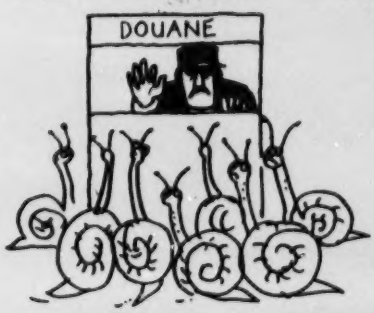
Trade grew very quickly after World War II — even more quickly than the world's economies — and countries are more interdependent economically today than ever before. Rapid economic growth in the world combined with a reduction in barriers to trade helped to produce this result. However, in recent years economic growth has slowed down, trade has stagnated and a "new protectionism" has arisen in the form of non-tariff barriers. An interesting example of this protectionism is given in the following clipping from *The Economist* of December 4, 1982.

Snails a protected species

PARIS

First it was Japanese video recorders. Now Turkish snails. Nothing, it seems, is safe from creeping French protectionism.

While mountains of video machines pile up at the only and tiny customs post in France now allowed to handle them, the government has decreed that imported snails must go through more rigorous veterinary checks before being sold in France. This means they can be given a clean bill of health only at customs posts equipped with snail-testing machines.



Until now they could be brought through any of France's 400 entry points. The Jura region of east France, where most foreign snails go to be stuffed and tinned, has only one snail-checking post, and it is far from the routes normally used by importers.

A third of the 2 billion snails the French eat each year come from abroad, mainly from Turkey and eastern Europe. France's annual trade deficit in snails runs to FFr150m ($21m). The agriculture ministry has been encouraging the development of domestic production, partly to combat the havoc wrought on home-bred species by hunters. Snail farmers are happy with their new protection, but the firms which process the imported snails say that customs delays may leave them with a lot of dead ones.

When he restricted imports of video recorders, Mr Michel Jobert, the foreign trade minister, said that the French do not need foreign video recorders at all. He would not dare to make the same assertion about snails.

THE ECONOMIST DECEMBER 4, 1982

We have already referred in earlier sections to GATT — the General Agreement on Tariffs and Trade — and this institution must be given credit for helping to dismantle barriers to trade in the period after the war and trying to restrain the growth in protectionism at the present time. The GATT is an agreement between the contracting member countries which is based on the principles of non-discrimination and reciprocity. Non-discrimination means that any member extending tariff reductions to one member must extend them to all members. This is known as the *most favoured nation* (MFN) principle, and the most important column in Canada's tariff schedule is the one giving MFN rates. This principle of non-discrimination is waived, however, in the case of preferential tariffs for developing countries, for preferences that predate the founding of GATT such as Commonwealth Preference, and in the case of regional groups such as the European Economic Community, where the members eliminate tariff barriers on substantially all trade among themselves. Reciprocity is based on the idea that concessions on tariff barriers by one member should be matched by concessions on the part of other members, but this is once again waived in the case of developing countries. There are some 88 signatories to GATT, and a secretariat which oversees the agreement and attempts to settle disputes is located in Geneva.

The tariff cutting under GATT has taken place in a series of bargaining rounds. The first five were relatively minor, with the United States and Canada making concessions which were not always matched by the European countries who were still recovering from the war. The sixth round was known as the Kennedy Round because the initiative for it came from President Kennedy. Instead of concessions by individual countries, Kenendy proposed an across-the-board cut of 50% in member countries' tariffs, the elimination of tariffs in the United States below 5%, and the elimination of tariffs on items where the United States and the European Economic Community together accounted for more than 80% of trade. While these objectives were not completely realized, after five years of bargaining a cut in tariffs of about 35% was agreed to in 1967. Canada participated in the Kennedy Round, but pleaded that it was in special circumstances with most of its exports in primary products and a relatively small manufacturing sector that required protection, and as a result Canada made only some selective tariff cuts.

The seventh round of bargaining was called the Tokyo Round because the declaration to begin the formal negotiations was signed at Tokyo in 1973. This round was concerned in particular with non-tariff barriers, and agreement was reached on codes governing such things as customs valuation, government procurement, anti-dumping duties, and export subsidies and countervailing duties. In addition, there were across-the-board tariff reductions according to a complicated formula which produced reductions in the range of 25% to 30%. This time Canada was not exempted from the general tariff cut, although exemptions were allowed for all countries for "sensitive" industries. Agreement was reached in 1979, and the cuts began in 1980 and are to be in place by January 1, 1987.

We have already noted that the slowing down of growth in the world's economies in the 1970s and 1980s has resulted in a rebirth of protectionist policies, and although GATT has turned its attention to non-tariff barriers it is far from clear that it will be able to stem the tide. We have seen that Canada has joined in this game, as evidenced by the quantitative restrictions on clothing, shoes and cars, the increased use of anti-dumping duties and countervailing duties, the favouring of local firms in government procurement, more rigorous inspection procedures for Japanese cars, and so on. It is reminiscent of the 1930s when countries tried to solve their own unemployment by cutting back on imports. But this is a beggar-your-neighbour remedy. Our imports are some other country's exports, and when their export industries are hit by unemployment they will retaliate and cut back their imports, which means unemployment in our export industries. The end result is less trade and gains that go with it, but no more employment.

Governments reaffirm their commitment to free trade when they attend international conferences, but at home they become increasingly protectionist. Once again Canada is no exception, and in November 1982 a ministerial meeting of GATT was held at Geneva where the Canadian Minister for External Affairs, Allan MacEachan was the Chairman. The result was a weak resolution wherein member countries agreed to "resist protectionist pressures", to study further trade in agriculture and services and to examine safeguards which are used to protect industries hit hard by imports. *The Economist* called it the "mad Gatters' tea party", and the picture below shows the French Minister for foreign trade, the Director-General of GATT, and the Canadian External Affairs Minister.

Grim Gatters: Jobert, Dunkel and MacEachan

A further important dimension to the trade policy problem is the dire straits in which the developing countries find themselves. Burdened with large debts, facing high prices for imported petroleum and manufactured goods, but declining prices for many of their primary products, these countries must be able to export goods to stay afloat. The poorest of them will have to receive increased aid in order to survive. However, they find that the markets of the developed countries are shrinking as a result of recession. Moreover, the goods which they can produce more cheaply are being kept out of the industrialized countries in order to preserve employment there. It is true that most of the developed countries extend preferential tariffs to the developing countries, but these are precisely the goods exempted from preferences and subject to quantitative restrictions or other protective devices. For example, textiles and clothing are usually governed by bilateral agreements negotiated under the Multi Fibre Agreement (MFA), which severely limit any growth in exports of these products from developing countries.

In the foregoing sections, then, you should have got some idea of the complexity of the problems facing Canada as she tries to formulate a trade policy for the 1980s. The manufacturing sector of the country is relatively inefficient, at least partly as a result of tariff protection for over a century. To remedy this requires increased specialization and exports, and consequently access to larger markets. The changes required may cause some unemployment in the short run and it is difficult to accept this in an economy which seems to have forgotten how to grow. We would like to diversify our markets and increase sales to the European Economic Comunity, Japan and the developing countries, but in spite of government efforts in that direction, our trade remains concentrated with the United States. Consumers want access to cheaper goods, and we surely have some obligation to help the development of the less fortunate countries of the world.

We could pursue freer trade on a *multilateral* basis through negotiations under GATT, but at the present time this institution has its hands full trying to restrain growing protectionism. *Bilateral* free trade with the United States might be a possibility, but we have seen that this course is not without its problems. It does not seem likely that we would take down all our own tariffs *unilaterally* without gaining equivalent concessions from our trading partners. However, if we do not adjust we continue to bear the costs of inefficiency and move further away from becoming internationally competitive in an increasingly interdependent world economy.

8 *Activity*

1. What do you think should be the main objective of Canadian trade policy, and why?

   (a) gaining tariff free access to wider markets?

   (b) restructuring Canadian industry before we go for free trade?

   (c) promoting growth in developing countries?

   (d) cheaper imports for consumers?

   (e) reduced imports and greater self-sufficiency?

   (f) other?

2. What type of policy should be used to achieve this objective, and why?

   (a) multilateral?

   (c) unilateral?

The Balance of Payments

The balance of payments is a record of all the international transactions of a country in a given period of time, usually a year. All transactions which give rise to a receipt of foreign currency are positive, or credit, items. All transactions which give rise to a payment of foreign currency are negative, or debit, items.

Exports of goods, like copper and cars, produce receipts of foreign currency and are positive items. Imports of goods, like coffee and cars, give rise to a payment in foreign currency, and are negative items. Exports of services, like shipping and insurance, produce foreign exchange change and are positive. If we lend money to other countries and they pay us interest on that money, this gives rise to a receipt of foreign currency and is a positive item. On the other hand, imports of services like shipping, insurance and payments for the use of other countries' capital require foreign exchange and are negative items. If Canadians travel to other countries and use foreign currency to pay their bills, this requires foreign currency and is a negative item. If Americans travel in Canada this produces foreign currency and is a positive item. If people in other countries give money to Canadians, such as in a will, or bring money with them to Canada, this is called a transfer item, and is positive because it gives rise to a receipt of foreign exchange. Finally, and importantly, if Canadians borrow money in other countries, or people in other countries invest in Canada, this gives rise to a receipt of foreign currency and is a positive item. If Canadians lend money to people in other countries or invest in other countries, for example, buying stocks on Wall Street, this requires foreign currency and is a negative entry in the balance of payments.

9 *Activity*

In the following situations, will there be a positive or a negative entry in the Canadian balance of payments?

(a) the sale of softwood lumber to the United States to use for building homes
(b) travel by Canadians to Hawaii for winter vacations
(c) Canadians playing hockey for U.S. teams in the NHL
(d) Canadians importing fresh lettuce from California
(e) Ontario Hydro borrowing money in New York
(f) Volkswagen in the U.S. buying a Canadian plant in Barrie to produce parts
(g) Canadian investors buying stocks in New York
(h) Canadians sending money to relatives overseas
(i) the Canadian government paying its contribution to the United Nations
(j) Americans going skiing in the Laurentians.

All of the entries in the balance of payments are grouped under certain headings. The current account includes all the items resulting from trade in goods and services and transfer items. If exports of goods and services are greater than imports of goods and services, this means that the international sector adds to total demand in the country and tends to increase national income. It also means that positive items are greater than negative items and there is a surplus or favourable balance in the current account.

All the items which concern payments and receipts for financial assets are grouped in the capital account. If the inflow of capital exceeds the outflow of capital, then the positive items are greater than the negative items and there is a surplus on capital account.

If the balance on current account just offsets the balance on capital account, that is it is equal and opposite in sign, then receipts of foreign currency will exactly match payments of foreign currency. If this is not the case, then the government will have to make up the difference by employing foreign exchange reserves. If positive items in total exceed negative items, then receipts of foreign exchange are greater than payments, and the government will add to its reserves of foreign currency. If negative items exceed positive items, then payments are greater than receipts, and the government must draw on its reserves of foreign exchange to make up the difference. The Bank of Canada holds the country's foreign exchange reserves on behalf of the government, and they are composed of foreign currencies (chiefly U.S. dollars), gold and drawing rights at the International Monetary Fund. We will discuss these reserves in more detail in a later section.

If all of the international transactions were properly recorded, the total of all positive and negative entries would add up to zero. (Since the records are not perfect, there is an item for errors and omissions which brings the total to zero.) This does not mean, however, that there will be, or should be, a zero balance in any one section of the balance of payments if we are considering only one type of transaction. The difference between all the positive and negative entries for trade in goods gives us the balance on merchandise trade. The difference between the positive and negative items for trade in goods *and* services and transfers gives us the balance on current account. The difference between the positive and negative entries for current account and capital account together gives us the official settlements balance, and is the same as the change in foreign exchange reserves, except in years when we are given new reserves by the International Monetary Fund without having to make any payment for them.

If receipts exceed payments in a particular section, then we have a positive or favourable balance in that section. However, the fact that the balance on any part of international payments is positive or negative is neither good nor bad in itself, but must be examined in light of the country's objectives, and the history of its international transactions over a longer period of time. It is obvious, however, that a country can only run down its foreign exchange reserves as long as they last, so that a continued negative balance on international payments on an official settlements basis beyond this point is dependent upon being able to borrow further amounts of international reserves from some source.

10 *Activity*

The following figures show some of the main categories in Canada's balance of international payments for 1981. The figures are in millions of dollars.

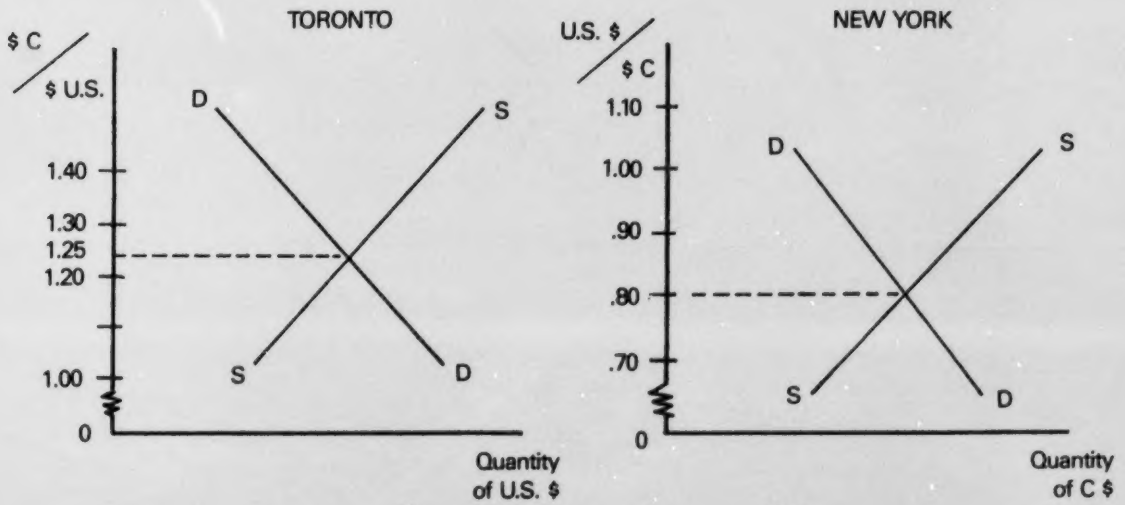
	Exports	$ 84,221
	Imports	76,870
–	Balance on Merchandise Trade	
	Services: Receipts	15,247
	Services: Payments	29,505
	Transfers: Receipts	3,075
	Transfers: Payments	1,514
–	Current Account Balance	
	Long Term Capital	+ 558
	Short Term Capital	+ 15,072
–	Balance on Capital Account	
	Errors and Omissions	– 9,068
–	Official Settlements Balance SDRs*	210
–	Change in Official Reserves	1,426

* SDRs represent new reserves in the form of Special Drawing Rights given to Canada by the International Monetary Fund.

1. Add the necessary positive and negative signs to the items in the Current Account.
2. What is the balance on international payments in the following areas?
   (a) the balance on merchandise trade
   (b) the balance on services
   (c) the balance on transfers
   (d) the balance on current account
   (e) the balance on capital account
   (f) the official settlements balance
3. Was the change in official reserves an increase or decrease?
4. In what areas does Canada have a deficit in her balance of payments? How serious a problem do you think this is?

THE FOREIGN EXCHANGE MARKET

We have seen that some international transactions give rise to a demand for foreign currency, and that some give rise to a supply of foreign currency. The market where this demand and supply interact to produce a price is the foreign exchange market, and the price which is determined is the foreign exchange rate. The market where Canadian dollars are turned into American dollars is located in Canada and centred in Toronto. On the other hand, there is a market in New York for Canadian dollars, which is just the same transaction looked at from the other side. Consequently, the price of the American dollar in Canada and the price of the Canadian dollar in the United States are simply the reciprocal, or upside down, of each other. If the American dollar costs $1.25 Canadian in Toronto, the Canadian dollar will cost 80¢ U.S. in New York, since $\frac{1}{1.25}$ is equal to .80. Canadians tend to refer to the value of the Canadian dollar as the exchange rate, although it would be more correct to call the price of the American dollar the exchange rate, since it is the price of foreign exchange. However, since one is simply the reciprocal of the other, this does not make much difference as long as we are entirely clear to what we are referring. Notice, however, that if it costs 20¢ less for the Canadian dollar in the United States, it will cost 25¢ more for the American dollar in Canada — not 20¢ more.



The demand for American dollars in Canada may come from many places — firms importing goods from abroad, Canadians travelling to the United States, investors wishing to purchase stocks on Wall Street — all those negative entries in the balance of payments. Similarly the supply of American dollars comes from many sources — Canadian exports, American tourists or investors — all those positive entries in the balance of payments. Each time a transaction involving the changing of one currency into another is made, this is part of the foreign exchange market.

Most of us make these transactions with a bank, so that when you wish to buy American dollars you go to your bank and get the currency, or money order or travellers' cheques that you desire. The branch of the bank with which you do business will quote you a rate given to them by their head office, and that rate may not be the same at all banks, although competition will keep it nearly so. This rate is based on the rate established in the interbank market in which the participants are the chartered banks and the Bank of Canada, and where the minimum transaction size is $1 million dollars. The rate set in this market is the one which is recorded in the newspaper each day, and the rate which you pay at your branch is related to it but slightly higher, reflecting the margin which the bank requires for providing the currency to you in smaller amounts. Of course, if you are selling foreign currency, you will get a rate slightly below the rate set in the interbank market.

11 *Activity*

1. Consult the foreign exchange market quotations in the **Globe and Mail Report on Business**, or some other financial newspaper, and find the closing price of the American dollar in Toronto, and the closing price of the Canadian dollar in New York. Is one the reciprocal of the other? How did each value change over the day, and how do you explain this?

2. Call the branches of the banks nearest you and find out what price they are asking for American dollars, and what price they will give you if you want to sell American dollars. Are the prices the same at all banks? Is there a difference between the buying and selling prices? Do the prices depend upon how much you want to buy or sell?

The Foreign Exchange Market

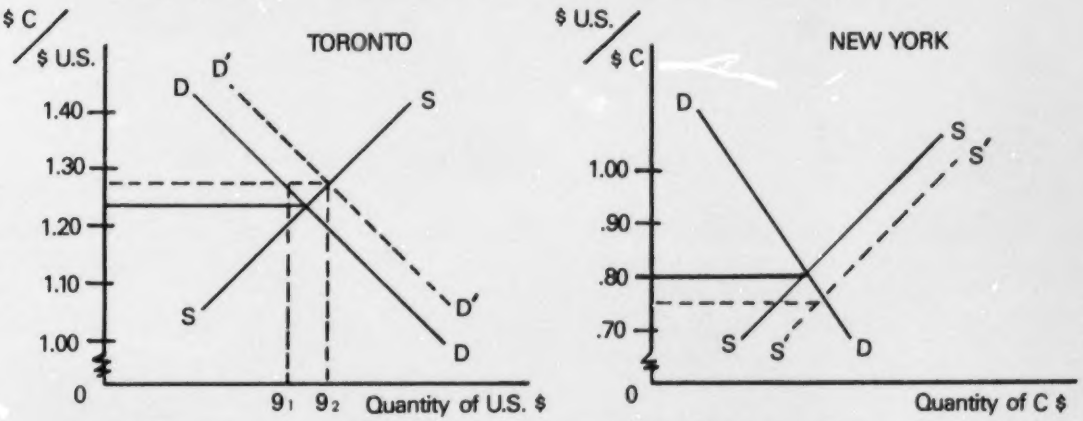
In looking at the foreign exchange quotations in the paper, you will notice that there are prices quoted for many currencies besides the American dollar. The markets for all these foreign currencies work in much the same way, but since most of our trade and investment takes place with the United States, this is much the most important market. Indeed, even when trade and investment does not take place directly with the United States it may still involve U.S. dollars. For example, oil is paid for in American dollars and most investments in the Eurocurrency markets are made in U.S. dollars. The U.S. dollar is the "vehicle" currency for most international trade and investment. Consequently, it is the most important single foreign currency for other countries as well. The most active markets are between each country's currencies and the U.S. dollar, and the price of currencies other than the U.S. dollar are derived by taking the price of the U.S. dollar and multiplying it by the U.S. dollar price of the other currency. For example, if $1 U.S. cost $1.25 Canadian, and £1 (English pound sterling) costs $1.60 U.S., then £1 will cost $2.00 Canadian.

We have seen that the price of the Canadian dollar in New York is the reciprocal of the price of the American dollar in Canada. If this were not the case, traders in either centre could supply their needs more cheaply by dealing in the other market, and would do so until the rates came into line. Moreover, they could make a profit by doing so. For example, if the U.S. dollar price were $1.25 in Toronto, but the Canadian dollar cost 79¢ in New York, Canadian traders in the interbank market could sell American dollars for $\frac{1}{.79}$ = $1.2658 in New York. They could buy them for $1.25 in Toronto and at the same moment sell them in New York for $1.2658, which on the minimum purchase of $1 million U.S. would mean a profit of $15,800 Canadian. This process is called *arbitrage*. It takes advantage of different prices in different markets for the same thing at the same time, and involves no risk. It is different from speculation which tries to take advantage of different prices over time, and does involve risk. In the above situation, the purchase of American dollars in Toronto would push up the price, while the extra selling in New York would push down their price there, until there was no possibilty of profitable arbitrage. It is the possibility of arbitrage which ensures that the prices in New York and Toronto will always be reciprocals.

12 *Activity*

1. Consult the foreign exchange quotations in the paper once again and find the closing price for the £ in terms of U.S. dollars. Remembering the closing price for the U.S. dollar in terms of Canadian money from the previous activity, what should the closing price of the £ be in terms of Canadian currency? What is the closing price given?
2. If the American dollar costs $1.25 in Toronto, and the Canadian dollar were quoted at 81¢ U.S. in New York, how could a trader profit through arbitrage? What effect would such arbitrage have on the two exchange rates?

The diagrams below are the same as the ones given earlier. They show the market for the U.S. dollar in Canada (Toronto), and the corresponding market for the Canadian dollar in the United States (New York). The price of the U.S. dollar in Toronto is $1.25 Canadian, while the price of the Canadian dollar in New York is 80¢ U.S.



Let us now suppose that the Canadian subsidiaries of American multinational companies wish to send part of their profits back to their American parents in the form of dividends. If the Canadian subsidiaries go to banks in Canada and buy U.S. dollars with Canadian funds, the situation would be as shown in the left hand diagram. The demand for U.S. dollars has increased from DD to D'D' and the price of the American dollar has risen. Alternately, these companies might simply send a cheque in Canadian funds to their parent companies, and when these parent companies take the cheque to their banks in the United States this becomes an increased supply of Canadian dollars to be turned into U.S. funds. This would appear as shown in the diagram on the right, where supply has increased from SS to S'S' and the price of the Canadian dollar has decreased. The rise in the price of the U.S. dollar and the fall in the price of the Canadian dollar are two ways of looking at the same thing. While the transaction might take place in either market, the change in price would take place in both markets, for as we have seen, the possibility of profitable arbitrage will ensure that the prices in the two markets are consistent.

Prices in the two markets will move in a consistent manner in response to changes in demand and supply. However, if the Bank of Canada does not want the value of the Canadian dollar to fall, in the above example, it could prevent this by meeting the increased demand for American dollars with U.S. dollars from the country's foreign exchange reserves. As we have seen in the preceding section, this will show up in the balance of payments as a decrease in reserves. In the above diagram, it would equal the distance q_1-q_2. On the other hand, if the Bank of Canada were trying to prevent a rise in the price of the Canadian dollar as a result of increased demand, it would have to supply Canadian dollars in exchange for U.S. dollars, and as a result the foreign exchange reserves would increase. We will discuss in a later section the extent to which the authorities intervene in the markets in this way.

13 *Activity*

1. On separate diagrams for the U.S. dollar in Canada, illustrate each of the following changes. How would the price of the U.S. dollar be affected in each case?
   (a) decreased sales of Canadian lumber to the United States
   (b) increased travel by Canadians to Florida
   (c) increased borrowing by Hydro Quebec in New York
   (d) reduced investment by Canadians on Wall Street
   (e) higher inflation in Canada than in the United States.
   Would this affect both supply and demand?
2. Show each of the changes in question # 1 on diagrams of the market for the Canadian dollar in New York, and determine the effect on the price of the Canadian dollar. Are your answers consistent with those in question # 1?
3. On one of your answers in question # 1 where the price of the U.S. dollar rises, and thus the price of the Canadian dollar falls, show how the Bank of Canada would have to intervene to keep the price of the Canadian dollar from falling. In another answer where the price of the U.S. dollar falls, and thus the price of the Canadian dollar rises, show how the Bank of Canada would have to intervene to keep the price steady. Why might it want to do this?

CAPITAL FLOWS

When we looked at the Canadian balance of payments for 1981, we saw that Canada exported more goods than she imported, or had a surplus on merchandise trade; but when services and transfers were included, Canada imported more than she exported, or in other words Canada had a deficit on current account. This has been the usual state of affairs in Canada for the past twenty years, although in 1982 Canada had a surplus on current account. Canada finances the deficit on current account by means of the surplus on capital account, meaning that capital inflows are greater than capital outflows. In many years this has enabled Canada to have a surplus overall in the balance of payments on an official settlement's basis, and to add to her foreign exchange reserves.

We can see, then, that capital flows are very important to Canada, and that over the years Canada has been on balance a capital importer. Capital inflows can take different forms. *Direct investment* occurs when the foreign investor has control of the operations of the business acquired, whether the firm is a new operation or a takeover of an existing business. *Portfolio investment*, on the other hand, involves a capital flow which does not result in control, and involves a foreigner buying stocks or bonds simply as an investment.

14 *Activity*

1. Which of the following capital flows represents direct investment, and which constitutes portfolio investment?
   (a) General Motors in the United States lending money to General Motors of Canada to build a new engine plant.
   (b) Prudential Assurance Company of America buying stock in Bell Canada.
   (c) American investors buying bonds issued in New York by Ontario Hydro.
   (d) Electrolux of Sweden buying Pioneer Chain Saw of Peterborough, Ontario.
   (e) Petrocanada buying some of the Canadian operations of British Petroleum.

Do you remember Sir John A. Macdonald's National Policy? It was mentioned in an earlier section. One of the objectives of the National Policy was to get American firms to set up branch plants in Canada in order to get around paying the tariff. This would be direct investment. It did occur as expected, but it was not the main type of investment up until World War I. The major part of the capital inflow in those years was in the form of portfolio investment from England, as British investors bought Canadian bonds. This type of capital inflow requires a capital outflow later on, as the borrower pays the interest on the loan and pays back the principal at maturity. This type of debt disappears as the loans are paid back, and Canadians had paid back much of this borrowing by the end of World War I.

Since World War I the capital inflow in Canada has been much more in the form of direct investment, at least until recent years, and the most important source of these funds has been the United States. This type of inflow reached its peak in the early years after World War II as Americans helped to finance the development of Canada's natural resources.

The issue of foreign investment in Canada has become one of the country's most hotly-debated topics. The additional capital which has been made available as a result of the foreign investment has allowed Canada to grow more quickly and has provided jobs. The direct investment from the United States has also brought management skills, sales to parent companies and access to the research and development done at the parent companies. On the other hand, the actual amount of money brought in may not have been very large, as American firms borrow money in the Canadian capital market to finance their investment, perhaps crowding out Canadian borrowers in the process. Since much of the investment has been in the resource industries which require a large amount of capital relative to labour, the amount of employment created may not have been as large as expected. American subsidiaries tend to import supplies and components from American companies rather than buying them from Canadian companies. It has been said that American subsidiaries do not try to make export sales, particularly if this would mean competing with the parent company. The United States has a law which prohibits "trading with the enemy", and they apply this to subsidiaries of American companies operating in other countries if they can. For example, Ford of Canada was prohibited from selling trucks to Communist China because of this law. Canada's reliance on imported management, research and development may have kept us from developing our own skills in these areas. Canadian nationalists are most concerned with the lack of independence which results from the high proportions of many of our key sectors that are controlled from abroad — over half of manufacturing, and much higher percentages of mining and oil and gas, for example. This concern has led to such government initiatives as the Foreign Investment Review Agency (FIRA) and the National Energy Program (NEP). FIRA was set up to screen new foreign investment to ensure that it brings substantial benefits to Canada. The NEP was designed to bring at least 50% of the Canadian oil and gas industry under Canadian control.

The year is 1963. Do you recognize the characters?

It is not clear exactly who the person in the Maple Leaf apron might be, but the "I Like Walt" button is obviously a reference to Walter Gordon, the Canadian Minister of Finance at the time. The first panel refers to the June, 1963 budget when Gordon introduced legislation to tax takeovers of Canadian business. The objective was to keep out foreign direct investment. About a month later, the American government introduced the interest equalization tax which was designed to keep American capital at home. Bonds issued by foreigners in the United States would be subject to a tax so that the cost of borrowing in the United States would be the same as borrowing in the foreigner's own country. The second panel, then, depicts President Lyndon Johnson taking his money back. Canadian politicans immediately went cap in hand to Washington to ask for exemption from this legislation. The third panel illustrates their indignation. The reasoning was that we needed an inflow of *portfolio* capital, but not *direct* foreign investment. In the end, the takeover tax was dropped, and Canada was exempted from the Interest Equalization Tax, but the whole eposide clearly illustrates Canada's ambivalence about foreign capital inflows.

It was mentioned earlier that borrowing in the form of bonds requires the borrowers to pay back interest and principal on time, or else be in default on their obligations. With direct investment, however, payment is in the form of dividends, and these do not have to be paid if profits are not earned. Consequently, direct investments does not require a regular payment regardless of the success of investment, as is the case with bonds. On the other hand, direct investment is never usually paid back. Indeed companies keep some of their profits in the company, and these retained earnings help to finance growth. By the same token, the value of the investment increases over the years without any additional capital inflow into Canada, so that foreign direct investment continues to increase in value even if there are no additional funds coming into Canada.

By the middle 1970s a further change had occurred in the form of the capital inflow. The net flow of direct investment into Canada has become negative — that is, outflows of direct investment from Canada to other countries (including repurchases of foreign owned firms) exceed inflows of direct investment from abroad. However, Canada continues to be a capital importer, and this has once again taken the form of borrowing, or portfolio investment. An important development in international capital markets has been the Eurodollar market — the market for lending and borrowing U.S. dollars outside of the United States. Provinces, municipalities and corporations that are large enough to float loans in foreign markets have found it cheaper to borrow outside of Canada — in New York and in the Eurodollar market. However, with much higher interest rates of recent years, such borrowing has been expensive, even though it may be cheaper than borrowing in Canada. As a consequence, Canada is facing higher interest payments for past borrowing with every year.

The current picture in Canada is that payments of interest for past borrowing, and of dividends on past direct foreign investment, are putting an increasing burden on the Canadian balance of payments. As we have seen, this contributes to the deficit on services which usually outweighs the surplus which Canada normally shows on merchandise trade. If we continue to import capital to offset the current account deficit, and if this capital is in short term funds, we may find monetary policy in Canada geared to keeping short term interest rates high enough to make the movement of short term funds into Canada attractive compared with other alternatives. The Bank of Canada's monetary policy more often appears to be directed toward maintaining higher interest rates in Canada than in the United States, than in setting interest rates at levels considered appropriate to the Canadian economic situation. Another alternative, however, is to allow the value of the Canadian dollar to change, and we will examine this in more detail in the following section.

15 *Activity*

1. List some of the benefits of foreign direct investment mentioned in this section. List some of the costs of foreign direct investment mentioned in this section. Do you think the benefits outweigh the costs, or vice versa?

2. The prime rate is the rate of interest on loans which banks charge their best customers. Consult the money market quotations in the **Globe and Mail Report on Business**, or some other financial newspaper, and compare the prime rate in Canada with that in the United States. Which is higher and by how much? Are rates on other money market loans consistently higher in Canada?

3. Draw a diagram for the market for the Canadian dollar similar to the one we used in the section on the Foreign Exchange Market, and show what happens to the value of the Canadian dollar if Canadian interest rates fall relative to those in the United States. Are both capital inflows and capital outflows affected?

THE CANADIAN EXCHANGE RATE

In the section on the foreign exchange market we discussed the way in which the values of currencies are determined in the marketplace, and we noted that the market for foreign exchange in Canada is dominated by the market for the U.S. dollar. While the price in this market might well be called the exchange rate, we will be talking about its reciprocal, the value of the Canadian dollar, when we talk about the Canadian exchange rate.

We also noted in previous sections that Canada typically imports more goods and services than she exports, that is that she has a deficit on current account. On the other hand, Canada typically imports more capital than she exports, or in other words, Canada has a surplus on capital account. These deficits and surpluses are affected by the value of the Canadian exchange rate. A lower value for the Canadian dollar means that goods priced in Canadian dollars are cheaper in other countries, and so our exports should sell better. At the same time, a lower value for our dollar means a higher value for the American dollar and a higher price for imports into Canada, so that we will buy less of them. An increase in exports and a decrease in imports should improve the balance on current account, and so a depreciation of the Canadian dollar would work towards eliminating a deficit on current account.

In Canada's case the analysis is a little more complicated since many of our exports are raw materials or primary products whose price is quoted in world markets in terms of American dollars. In this case the price does not change if the Canadian dollar goes down in value, but instead Canadian producers get the same price in U.S. dollars which means a higher price in Canadian dollars. These exports become more profitable if the Canadian dollar depreciates, and in the long run these higher profits may result in increased production and greater exports. However, the amount of exports is more dependent upon demand in these other economies, so that increased exports depend to a large extent upon high levels of income in other countries.

A current account deficit may or may not be a good thing. If long term capital enters Canada because of more profitable investment opportunities here than in other countries, it will give rise to increased imports. In this way our resources are increased beyond what we are able to produce ourselves and the capital allows us to grow more quickly than we could if we were limited to our own resources. On the other hand, a current account deficit might simply mean we are "living beyond our means". If more foreign funds are needed to pay for imports of goods and services than are available from sales of our exports of goods and services — that is, we have a deficit on current account — these funds may be available from a capital inflow, or the shortage of foreign funds may bring about a higher price for these funds. In other words the value of the Canadian dollar will depreciate. A current account deficit may be financed by a capital inflow, or it may be eliminated by a depreciation of the Canadian dollar. The correct policy depends upon the circumstances.

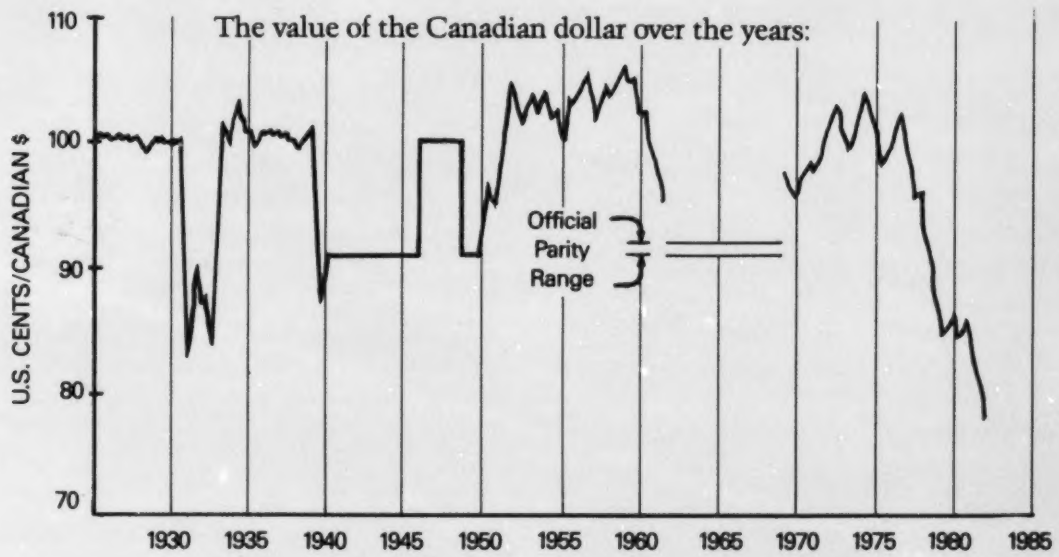
16 *Activity*

1. Refer back to the section on Canadian trade and identify some of Canada's main exports. How would sales of these exports be affected if the Canadian dollar went down in value relative to the American dollar? How would total proceeds be affected?
2. What are some of Canada's principal imports? How would sales of these imports be affected if the Canadian dollar went down in value? Might we now produce more of these imports in Canada?
3. How would trade in services be affected if the Canadian dollar went down in value relative to the American dollar? What about tourism? What about interest payments on past borrowing abroad?
4. How would you expect imports and exports of goods and services to be affected if the Canadian dollar went up in value relative to the American dollar?

The Canadian Exchange Rate

The value of the Canadian dollar has varied over time, and the policy with respect to the value that it should have has also been subject to change. In the last century, when the gold contents of currencies determined their relative values, Canada chose the same content for its dollar that the American dollar had. This meant that the two dollars were equal in value, and is the basis for the idea that this is in some way the correct value for the Canadian dollar. The last attempts to tie currencies to gold ended in most countries between the World Wars, and Canada's currency has not been convertible into gold since the Bank of Canada opened in 1934 and took over responsibility for the Canadian money supply. Even before 1934, the Canadian dollar fell sharply in value relative to the U.S. dollar, and during the 1930s its value fluctuated in the marketplace, as can be seen in the chart below.

After World War II, Canada was one of a number of the victorious countries that set up the International Monetary Fund (IMF). It was decided to restore a system of fixed rates which could be adjusted if necessary, and Canada chose a value of equality with the U.S. dollar when the new regime went into effect in 1946. The value of the Canadian dollar had been set at 90.9¢ U.S. during the war, so this new value meant an upward movement, or revaluation, of the Canadian dollar. The government continued to control the exchange market after 1946, and it experienced some difficulty in maintaining this value for the Canadian dollar. The deficit which Canada ran with the United States was traditionally paid for by a surplus with other countries, but these other countries, particularly England, lacked the means of payment after the war. When England devalued in 1949, Canada feared that she would lose her competitive position and devalued the Canadian dollar back to 90.9¢ U.S., thereby keeping at least partly in line with the European countries which devalued by an even larger amount relative to the U.S. dollar at that time.



Adapted from Lipsey, Purvis, Sparks and Steiner, Economics, Fourth Edition, p. 148

By 1950 the tide had turned again, and Canada was experiencing a surplus and upward pressure on the exchange rate. Not knowing what rate to pick after changing in both directions since the war, the government decided to allow the exchange rate to be determined in the market, and a market was set up in 1950 free from government control which operates as described in the earlier section on the foreign exchange market.

The value of the Canadian dollar soon moved back to equality with the American dollar and then rose to a premium, or above the U.S. dollar in value, as foreign investment poured into Canada to help develop Canadian natural resources. This made Canadian exports less attractive and foreign imports more attractive, in accordance with the logic explained earlier; but this was appropriate in an economy where demands were greater than could be met. However, by the end of the 1950s, inflation was receding and unemployment was becoming the more serious problem, so that having the Canadian dollar at a premium was no longer as appropriate. Even less appropriate was a policy of tight money and high interest rates designed to counter inflation, and which had the effect of attracting capital to Canada, in this way keeping up the value of the Canadian dollar. The government decided to intervene more actively in the market, rather than simply offsetting sudden changes as they had been doing since 1950. There was a loss of confidence in the Canadian dollar, and the problem soon was transformed into one of keeping the value of the Canadian dollar from falling. In the first half of 1962 everybody wanted to sell Canadian dollars, and the run on the Canadian dollar reached crisis proportions. The only way that the government could keep the value of the Canadian dollar from falling was to buy it up with reserves of U.S. dollars, and these reserves were running low. Finally, the government decided to return to a fixed exchange rate and chose the value of 92.5¢ U.S. Shortly afterwards the government introduced an austerity programme which included higher interest rates, reduced government spending, extra tariffs on imports and borrowing from abroad, including the IMF.

The programme was successful in stopping the run on the Canadian dollar, and in a short time most of the measures were reversed. Once again Canada was conforming to the IMF rules, and the government intervened in the foreign exchange market to keep the value of the Canadian dollar between 91.575¢ U.S. and 93.425¢ U.S. (1% on either side of the official value). This is shown on the chart as the official parity range, and from 1962 to 1970 the value of the Canadian dollar stayed within that range.

17 *Activity*

1. How would the various measures taken by the government in the 1962 austerity programme help to strengthen the balance of payments and the exchange rate? Did the success of the policy indicate that the exchange rate chosen was correct?

2. Canada returned to a fixed exchange rate in 1962 and borrowed from the IMF and others to help defend that rate. If we had not returned to the fixed rate we would not have had to defend that rate. Would we have been better off to have let the exchange rate move and not worry about the IMF rules and borrowing reserves?

3. Was it the flexible exchange rate that failed to work, or was it government policies that caused the difficulties?

By 1970 Canada was running a current surplus, and the Canadian dollar appeared undervalued at 92.5¢ U.S. Speculators, wanting to buy the Canadian dollar while it was still cheap, added to the inflow of funds. This inflow made things difficult for the authorities who were trying to keep down inflation, because they were obliged to keep the value of the Canadian dollar from rising by buying up the excess U.S. dollars, and this put more Canadian dollars into circulation. In June 1970, just as in 1950, the attempt to resist upward pressure on the Canadian dollar was abandoned and the exchange rate was set free.

The Canadian Exchange Rate

Since 1970 the Canadian exchange rate has been free to move, but it has been subject to management by the authorities, who are the Bank of Canada acting on the instructions of the Minister of Finance. We call this system "managed flexibility". The value rose above equality with the American dollar in the mid 1970s as a result of capital inflows. By the later 1970s it became apparent that the Canadian dollar was once again overvalued. Canada now imported more oil than she exported, and money wages in Canada were equal to those in the United States without comparable levels of productivity to justify them in many industries. The value of the Canadian dollar has fallen sharply relative to the U.S. dollar in recent years. As we can see from the chart, by the end of 1978 it had fallen below 85¢ U.S. It remained in the range of 80¢-85¢ until 1982, when in July it fell to an all-time low of about 77 ½ ¢, before recovering back to a level above 80¢ U.S.

The correct level for the value of the Canadian dollar is a debatable point. The various forces in the market at any time reflect the trade in goods and services as well as capital flows, and the Bank of Canada also intervenes in the market. The question is whether this intervention should only be to smooth out temporary changes, such as was done in the 1950s, or whether the Bank should keep the rate at some level which they and the government consider appropriate. A lower level might encourage exports and discourage imports, but in 1982 the Bank of Canada took the position that such a decrease would add to inflationary pressure by pushing up the price of imports, while it would not improve the trade balance since the lack of demand for exports is a result of depressed conditions abroad rather than high prices for Canadian goods. Canada keeps relatively small foreign exchange reserves, and the government cannot afford to borrow funds to keep the rate up for any length of time. As long as the Bank is unwilling to let the exchange rate fall, they must keep interest rates sufficiently high in Canada to attract the capital required to offset the imbalance in the current account.

A different policy has been advocated by some critics who feel that lower interest rates in Canada would promote economic growth and employment. If the capital inflow stopped, or a capital outflow increased, this would cause the Canadian dollar to decline in value and this in time would lead to an improved position in the current account. This would also boost employment, and since there is a great deal of unused capacity these people feel that inflation is not really a threat. However, if people are concerned about inflation and a possible capital flight, the policy recommended to deal with this is controls on prices and foreign exchange, conditions which Canada last experienced in a full fledged way during World War II.

18 *Activity*

1. Do you think the Bank of Canada is doing the right thing in trying to keep the value of the Canadian dollar above 80¢ by keeping interest rates in Canada higher than in the United States? Why, or why not?

2. Do you know who the critics are who have called for lower rates of interest, and possibly a lower value for the Canadian dollar? Do you agree with their arguments? Why, or why not?

3. Looking at the chart for the value of the Canadian dollar, we can see that its highest value ever was at the end of the 1950s. We also noted that this high value was not appropriate in a time of unemployment, and was partly a result of high interest rates that attracted capital into Canada. The value was also at historically high levels in the 1970s, and once again interest rates were high relative to those in the United States. Was this also inappropriate? Does the same argument hold today?

4. Do you think the value of the Canadian dollar will ever return to equality with the American dollar? Why, and why not?

5. During 1982, the Canadian dollar fell in value relative to the American dollar, but rose in value relative to many other currencies. How do you explain this? (Hint: Look back in the section on the foreign exchange market to see how the value of the £ in Canadian dollars is determined). What did this mean for Canadians who travelled to Europe in 1982?

THE INTERNATIONAL MONETARY SYSTEM

The international monetary system was re-organized after World War II in accordance with what has been called the Bretton Woods system. This name comes from a conference held at Bretton Woods in New Hampshire in 1944, where plans were drawn up for two international organizations to help regulate financial matters after the war. The first of these organizations was the International Monetary Fund (IMF), and its primary purpose was to help countries overcome balance of payments difficulties in the short run until they could make more fundamental adjustment in the longer run. The sister institution was the International Bank for Reconstruction and Development, or World Bank, whose purpose was to provide long term capital to assist member countries in the task of rebuilding after the war and in the problem of development.

Member countries were assigned quotas in the Fund based on their relative importance in the world economy. They then contributed funds, originally in gold and their own currencies, in accordance with the size of their quotas. They have the right to borrow funds, also in accordance with the size of their quotas, in a time of balance of payments difficulties. They would do this by buying the foreign currencies which they need with more of their own currency, and they would pay this back by repurchasing their own currency with acceptable foreign currencies. Members were also expected to state a value for their currency in terms of either gold or the U.S. dollar. This value was fixed on a day-to-day basis, and members were expected to intervene in the foreign exchange market to keep the value of their currencies within 1% on either side of the stated value. However, members could adjust the value in the event of a fundamental disequilibrium in their balance of payments. There were originally 39 members with total quotas of $8.8 billion U.S. at the end of 1946, and at the end of 1982 there were 141 members with total quotas of over $66 billion U.S. Most of the countries of the non-communist world are members with the exception of Switzerland which has retained its traditional neutrality. The headquarters of the Fund are in Washington, and the chief officer is called the Managing Director. This post is normally not held by an American, and the current Managing Director is Jacques de Larosière.

The World Bank has mainly been concerned with promoting development rather than with reconstruction. Funds for the World Bank come to a small extent from members in accordance with quotas, but are mainly borrowed on world capital markets and lent to members at market rates. The World Bank has set up two subsidiaries to help in development: the International Development Association (IDA) and the International Finance Corporation (IFC). The IDA lends money to the poorest countries for periods of up to fifty years with no interest charge, and depends for its funds on donations from the richer member countries. The IFC helps to finance private industry in developing countries by buying stock and later selling it to other investors once the company has become established. The World Bank Group's headquarters are also in Washington, and its chief officer is called the President, currently A.W. Clausen of the United States.

Canada in the Bretton Woods System

Although England and the United States were the main architects of the Bretton Wood system, Canada sent a delegation to Bretton Woods which was quite influential in shaping the final agreements. The Canadian delegation included Louis Rasminsky, who later became the Governor of the Bank of Canada; W.A. Mackintosh who was later the Principal of Queen's University; John Deutsch who also became Principal of Queen's University and was the first Chairman of the Economic Council of Canada; and A.F.W. Plumptre who was later an Assistant Deputy minister of Finance and Principal of Scarborough College.

Canada was one of the founding members, and her original quota was set at $350 million U.S. Canada stated the value of her currency in 1946 at $1.00 U.S. In 1949 she devalued to 90.9¢ U.S., and in 1950 she deviated from the rules of the IMF by setting the Canadian dollar free to find its own value in the market. Canada returned to a fixed rate of 92.5¢ U.S. in 1962 and kept that rate until 1970, when once again the rate was set free. We have continued to have a flexible rate since that time.

In 1962, Canada borrowed $300 million U.S. to bolster her reserves at the time of the foreign exchange crisis, as described in the preceding section on the Canadian exchange rate. This money was all paid back to the IMF by 1964.

Canada's quota has been increased in each of the seven reviews of quotas which have been undertaken by the Fund. At the end of 1982 her quota stood at 2,035.5 million Special Drawing Rights, or SDRs, which was equivalent to $2245 million U.S. An eighth review of quotas is soon to be undertaken in which quotas may increase substantially.

The Managing Director is assisted in the day-to-day operations of the Fund by 22 Executive Directors. One of these is currently Robert K. Joyce of Canada, who represents this country as well as Bahamas, Barbados, Dominica, Grenada, Ireland, Jamaica, St. Lucia and St. Vincent.

Canada has contributed funds equal to $128 million U.S. to the World Bank, and $1,158 million U.S. to the International Development Association. This latter amount represents over 5% of the IDA's resources. Earl Drake is the Canadian Executive Director of the World Bank.

The annual meetings of the Fund and the World Bank Group are held in alternate years in Washington, and in the intervening years in the various member countries in turn. In September, 1982, the annual meetings were held in Toronto.

The Bretton Woods system started up in 1947, but it really took until 1958 before most of the industrialized countries had freely operating foreign exchange markets and the system was working as planned. By that time the American dollar had taken over the role of the basic international money, both in trade and to hold as foreign exchange reserves. Countries could earn interest on U.S. dollars while holding them as foreign currency reserves, and they were convertible into gold at the fixed rate of $35 U.S. per ounce of gold. In the years after 1958, continuing deficits in the American balance of payments were paid for by more U.S. dollars, but at the same time the large hoard of gold in the United States shrunk from over $20 billion to about $10 billion, as some countries converted their U.S. dollars into gold. People began to feel that the American dollar was overvalued, and they speculated against it by buying other currencies or gold. It became more and more difficult to maintain the fixed values for other currencies in terms of the U.S. dollar because of the increased demand for them, particularly the German mark, the Swiss franc and the Japanese yen. The price of gold was allowed to go free on the private market in 1968, the convertibility of the U.S. dollar into gold at a fixed rate was ended in 1971 by President Nixon, and in 1973 the system of fixed exchange rates broke down.

Since 1973 many of the world's major currencies have fluctuated in value with respect to the U.S. dollar, and these fluctuations have been quite large. Sometimes this reflects the differing rates of inflation in the various countries, but at other times it appears to be the result of capital flows and/or speculation. The IMF has amended its rules to permit flexible exchange rates, and all countries intervene in the foreign exchange market to manage that flexibility. The IMF is empowered to keep a watch on the actions of member countries, but it is not yet clear exactly what this might involve.

Another major development has been the creation of a new international reserve asset by the International Monetary Fund. It is called a Special Drawing Right (SDR), and we have already referred to it in earlier sections. Member countries are simply given an allocation of SDRs in accordance with their quotas. On request to the IMF these SDRs can be turned into convertible foreign currencies which can then be used

in the foreign exchange markets to help overcome balance of payments difficulties. These SDRs are sometimes called "paper gold", since they are international reserves which have been created by the stroke of a pen, but which member countries have pledged to accept up to certain limits. Real gold, meanwhile, has fluctuated in price on the private market, and reached a high of about $800 U.S. an ounce early in 1980.

The provision of SDRs and the move to flexible exchange rates has not meant an end to either the dominance of the U.S. dollar or to balance of payments difficulties. The latter are particularly related to the huge increases in oil prices engineered by the Organization of Petroleum Exporting Countries (OPEC). Oil is paid for in U.S. dollars and some of the countries which export oil cannot spend these U.S. dollars as fast as they earn them. Consequently, they run a current account surplus in their balance of payments, while oil importing countries run a deficit; the former have a capital outflow as they seek to invest, while the latter have a capital inflow as they seek to borrow. If each country could just attract the capital it needed to offset its current account deficit, then the short run problem of financing the oil deficit would be solved. However, some countries may not be able to finance their deficits. In this case, the surplus funds from oil exporters must be redirected from the countries where they are initially invested to those countries who require short term finance. This is known as recycling petrodollars. This recycling might be done by private markets such as the Eurodollar market where U.S. dollars are lent and borrowed outside the U.S. On the other hand, it might be done through public international institutions such as the IMF.

The problems arising from the first round of oil price increases in 1973-74 were solved by a combination of measures. The industrialized countries were able to adjust fairly quickly and reduce their deficits on current account, but the deficit was to a large extent transferred to the oil-importing developing countries. The better off developing countries were able to finance their deficits by borrowing on the Eurodollar market, while the poorer countries were assisted by the IMF. The oil exporters themselves imported more than was expected and so had lower surpluses as time went on. The higher oil price resulted in substitution of other energy sources and conservation, and because the oil price stayed fairly constant for a time after the initial sharp rise, the inflation of the 1970s reduced the price of oil in real terms.

The second round of OPEC oil price increases in 1979-80 raised similar problems. Demand for oil in the industrialized countries was reduced by recession and conservation, and there was a substantial switch to non-OPEC sources of supply. Deficits in the balance of payments were manageable, and eventually the price of oil declined. However, many oil-importing developing countries face huge deficits because of the high oil prices and the reduced demand for their exports in a time of recession. Moreover they are still struggling with the debts inherited from the last

round of oil price increases, and the high rates of interest in recent years have made that burden greater. Private banks and other lenders are reluctant to loan any more money to these countries. The threat of a major country not paying its debts and causing a collapse in world financial markets is very real. The IMF is an important actor in this drama. It has limited resources of its own to solve the problem, and the conditions it lays down for making loans to countries in need are thought by many to infringe on the countries' independence, and to work against their chances for development and growth. On the other hand, the supervision of the IMF is very much desired by private banks and other lenders as a condition for extending further credit to developing countries or rescheduling their existing debt.

19 *Activity*

1. What countries are presently in danger of not being able to pay their debts? Would a fall in the price of oil help them, or make their problem worse?
2. Canada gives money to the International Development Association (IDA) for them to lend to the poorest countries. It also gives money directly to developing countries through the Canadian International Development Agency (CIDA). The former is known as multilateral aid; the latter is called bilateral aid. Which method of providing aid is better in your opinion, and why?
3. If developing countries are to meet their debt obligations they have to be able to earn money to do so by selling exports. However, the recession in the industralized countries has shrunk their markets there, and what is worse, given rise to new measures of protection, as we have seen earlier. Does this mean that the rich countries are protecting their industrialists at the expense of their bankers?
4. At the end of 1982, Canada's foreign exchange reserves totalled $3.79 billion U.S. They were composed of $2,450 million in U.S. dollars, $120 million in other foreign currencies, $782 million in gold, $71 million in Special Drawing Rights (SDRs), and $69 million in a reserve position at the International Monetary Fund. The gold is valued at the rate of 35 SDRs per ounce (about $38.60 U.S.). However, the price of gold on the world market is much higher and Canada has been selling off some of its gold reserves. In December, 1982, it sold 66,000 ounces of gold at an average price of $368.18 to bring in $24.3 million U.S. Do you think it is a good policy for the government to sell off its gold reserves? Why, or why not?

Canadian Trade:

— The objective in this section is to provide an overview of the Canadian trade picture based on the actual trade figures, and then to go to explaining what might account for this picture, and how it might change in the future.

— The principle of comparative advantage is the most fundamental piece of analysis in displaying the gains from trade. The principle simply says that two countries can both gain in trading even if one country is more efficient in producing all goods than the second country. It is usually credited to David Ricardo and dates from 1817. No attempt is made to outline the analysis, but simply to state the principle and to illustrate it by analogy with a real life situation.

— The first activity simply tries to get students involved in looking at the trade statistics. The fact that Canada traditionally has a surplus in its merchandise trade is sometimes ignored in the continual lament over the deficit in our balance of payments, and so the point of the first question is to establish this fact by reference to the statistics for 1981. The second question simply tried to establish the relative importance of various categories of imports and exports (e.g. farm and fish products accounted for 11.7% of Canadian exports in 1981). The third question shows a deficit on trade in oil and gas (a surplus on gas more than offset by the deficit on oil), but Canada has a surplus in energy products when one includes coal (imported in Ontario but exported from the West), electricity and uranium. The fourth question illustrates the deficit in motor vehicles and parts which is the usual situation, although there may be a surplus in 1982. The figure is dominated by trade under the Auto Pact which is covered in a later section, but does include trade under the Auto Pact which is covered in a later section, but does include trade with all countries. The fifth question illustrates the positive balance on food and agricultural products, although there is a surprisingly large amount of food imports explained by tropical products like tea, coffee, citrus fruits, bananas and fresh fruits and vegetables. The last question simply reinforces the generalizations made in the text about the pattern of trade by areas, and illustrates a positive balance of trade with most other areas except other OECD Europe and Other America (oil imports from Venezuela). The categories of durable, non-durable and semi-durable under consumer goods refer to a distinction between goods like cars and refrigerators (durables), clothing (semi-durables) and soap (non-durable).

— The questions in the second activity are more arguable and less objective. The first question revolves around the idea that even if low wage countries did have an absolute advantage in producing everything, Canada would have a comparative advantage in production in some goods as long as they were not equally inefficient in all lines of production. Of course, Canada does have an absolute advantage in producing many goods, especially those based on natural

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resources, while the low wage countries have an advantage in goods which employ a large amount of unskilled labour. Low wages do not necessarily mean low labour costs, however, since labour costs are a function of not only wages but also productivity. The second question simply asks students to confirm that Canada's trade statistics reveal the advantage in raw material based goods, and disadvantage in manufactured goods. The question of whether to try to change this picture or simply exploit the existing patterns of advantage is a fundamental one about which people may reasonably differ.

Canadian Tariffs:

— The objective in this section is to describe what a tariff is and what its effects are, to describe the evolution of the Canadian tariff, to look at the effects of both Canadian and American tariffs on Canada, and to describe some non-tariff barriers to trade.

— A basic point in both the prose and the activity is to stress that a tariff redistributes income among groups in the country, and that consequently to approve of tariffs or to oppose them is to favour one group against another.

— The questions in the activity deal with one sector of the Canadian economy which is relatively highly protected, but which is not without its strengths. The tariff and the quota must raise prices at least 25% higher than they would otherwise be, and this applied both to imports and to the domestic production with which imports compete. The cost to an individual person is presumably about 1/4 of his average annual outlay for shoes. Anyone who advocates reducing protection should have some plan for relocating workers displaced by imports, and the fact that so many of them are in Quebec complicates the problem because of the already high unemployment in that province and the difficulties French workers would face in moving outside the province because of linguistic and social considerations. There are many Canadian firms that produce shoes and in some areas Canadian products are very competitive, for example, women's dress boots, winter boots, work boots. Some firms that come to mind are Greb, Susan shoes which produce the Cougar line, Bata which is a Canadian multinational with production in over a hundred countries. The area where Canadian firms are in trouble is mass produced shoes with a high labour content. Roots is an interesting case since it shows that Canadian companies can be competitive, but their strength is based on being leaders in style.

The Canada — U.S. Auto Pact

— The objective in this section is to review the problems of the Canadian automotive industry, how the Auto Pact attempted to solve some of these and how successful it was in this regard. This summary is then brought up to date by placing the debate in the context of the increasingly dominant role of Japanese cars.

— The questions in the first activity follow pretty directly from the clipping, with the last one asking the students to consider what might affect the trade figures in the future. The questions at the end in the second activity are much more subjective and designed to get the student to consider where he/she stands on some of the issues. There are no correct answers, but more or less reasonable arguments to be made, and as always in economics the necessity of making choices is fundamental.

Canada - U.S. Free Trade

This section tries to outline some of the economic and political considerations relevant to a discussion of free trade with the United States. Undoubtedly the students will bring up many more that are relevant. A recent discussion of some of the issues is in *Canadian Public Policy*, Supplement to Volume VIII, October, 1982.

The first activity tries to contrast the experience in the agricultural machinery industry with that in the automotive industry, since both have experienced free trade with the United States for some time. The basic point to be made is that free trade is no panacea, although since both industries are in difficulty it might be thought that free trade is the cause of the trouble.

There may be all kinds of reasons why free trade in agricultural machinery has not seen the same relative improvement in productivity that followed free trade in automotive products. However, one factor is probably that there is not so much scope for economies of scale in agricultural machinery. This is increasingly the case as machinery become bigger and more complex, so that there are fewer, but more expensive, machines produced.

The Canadian farm machinery company is Massey-Ferguson. It buys its inputs from plants all over the world, assembles them in many different countries, and sells the machines all over the world. For example, it produces diesel engines in Europe, puts them in tractors assembled in the United States and sells them in Canada. It assembles combines in Canada. Canada only accounted for 8% of its sales in 1968, although a slightly higher proportion of total employment. Massey is in great difficulty financially, and has been rescued by government aid, in particular purchase of preferred shares by the Ontario government. The other two large companies which produce a full range of machinery are International Harvester and John Deere. The former is on the verge of

bankruptcy like Massey, but Deere is in much better shape. Other firms are Allis-Chalmers, Case, etc., and in Canada, Versatile, which is based in Winnipeg has had some success exporting tractors and combines to the United States.

In the second activity the focus is on different reactions to free trade in different parts of the country. The western provinces have always felt disadvantaged by the protective tariff and would undoubtedly welcome free trade with the United States since it would mean they could buy goods more cheaply and perhaps expand sales of primary products to the States. On the other hand, since they do not have much manufacturing industry, the loss of tariff protection would not greatly affect them in this respect. The same situation probably faces the Maritime provinces. Ontario and Quebec face the prospect of substantial adjustment since that is where most of the protected manufacturing companies are located, but on the other hand their consumers would benefit.

Quebec has been identified as the region most dependent upon tariff protection, so it is not surprising that they are concerned about keeping it and thus their preferred access to the rest of the Canadian market, even if they achieve a greater degree of independence from the country in other respects. At the same time they would not particularly want to drop the existing protection against producers from outside Canada. The logic of this position would seem to support a Canadian bid for free trade with the United States.

There are barriers to trade inside Canada but they do not take the form of tariffs. Other than natural barriers such as transportation costs, governments impose barriers through preferential procurement policies whereby they buy goods from suppliers within their own provinces even they do not quote the lowest prices. Quebec has tried to restrict the inflow of construction workers, and also the flow of some agricultural products subject to regulation by marketing boards (for example, broiler chickens). Students may be able to think of other such restrictions.

The last question carries on from the final paragraph of the section, and really invites any number of possible responses from guaranteed access to Canadian oil and gas, to changes in the Auto Pact and Canadian policies such as the National Energy Programme and the Foreign Investment Review Act.

Trade Policy in the 1980's

The description of policy options in this section should be straight forward, although the difficulty of choosing the best option is certainly a matter for debate.

The objective of the Activity is to try to get students to make choices — to decide which objective *they* think is most important. Once they

have established their priorities, they can choose the policy best suited to getting them there. The idea is that no single policy is a panacea, and perhaps to get them to think critically about any suggestions which are put forward as such.

The Balance of Payments

The first activity is an application of the distinction made in the opening paragraphs between positive, or credit, entries that result from transactions giving rise to a payment of foreign currency, and negative, or debit, items that arise from transactions which result in a payment of foreign currency.

\+ (a) an export from Canada that is a positive entry in Canada's balance of payments

– (b) an import of services (tourism) from another country that is a negative entry

\+ (c) an export of services that is a positive entry, if the players bring the money they are paid back to Canada

– (d) an import that is a negative entry

\+ (e) an import of capital that gives rise to a receipt of foreign currency and is a positive entry. It may help to think of it as an export of bonds.

\+ (f) another import of capital, where the initiative this time comes from foreigners, but still gives rise to a receipt of foreign currency and a positive entry

– (g) an export of capital that is a negative entry. Once again some people find it helpful to think of it as an import of stocks.

– (h) a transfer item that results in a payment of foreign currency and is negative.

– This item is not specifically related to the United States dollar, but would still require some type of foreign currency and be a negative item.

– (i) another transfer item that requires a payment of foreign currency and is negative

\+ (j) an export of services (tourism) that gives rise to receipts of foreign currency and is positive.

The second activity is centred on a simplified statement of the Canadian balance of payments for 1981. This is a fairly typical year, except for the huge size of the errors and omissions figure. It is typical because Canada usually has a surplus on its balance of merchandise trade but a deficit on trade in services that is even larger, so that overall the balance of payments is negative on current account. This is what most people mean when they talk of a deficit in the Canadian balance of payments. However, in 1982 Canada will likely have a surplus on current account of about 2.5 billion dollars.

1. The exports, service receipts and transfer receipts are positive items. The imports, service payments and transfer payments are negative items.
2. (a) the balance on merchandise trade + 7,351
   (b) the balance on services − 14,258
   (c) the balance on transfers + 1,561
   (d) the balance on current account − 5,346
   (e) the balance on capital account + 15,630
   (f) the official settlements balance + 1,216
3. Since the surplus on capital account exceeds the deficit on current account, even after including the errors and omissions, there was an addition to reserves. The total change in reserves is the 1,216 resulting from transactions and the increase of 210 which comes from the allocation of SDRs to Canada by the International Monetary Fund. A really perceptive student might note that the figure for the change in reserves would have to be negative for all the entries to total to zero, and that is correct. A negative sign indicates an increase in reserves, and you can imagine why Statistics Canada has stopped presenting the figures in this way and trying to explain how negative means an increase. But an increase in reserves means taking U.S. dollars in exchange for ours, which is like accepting their IOUs or lending the money, and that would be a negative entry.
4. In 1981 Canada has a deficit on current account because the deficit on services outweighed the surplus on merchandise trade and transfers. However, there was more than enough capital inflow to pay for this, so that overall there was a surplus on an official settlements basis.
   Is the deficit on current account a cause for concern? As long as we can borrow the money to pay for it it may not be — but remember Mexico. The deficit on services results in large part from large payments in interest and dividends, in other words the cost of capital borrowed in the past. Some people view this as borrowing more to pay for past borrowing, and thus we are digging ourselves into an ever deeper hole. We are living beyond our means by not saving up enough to pay off past borrowings. Others argue that we need external savings because we cannot save enough ourselves to develop our resources, and that the inflow of capital gives rise to imports or machinery and equipment. Without the inflow of capital there would be a smaller current account deficit and less growth and low income as well. This is an area of great controversy, about which we will say more in the next section.

The Foreign Exchange Market

The objective in this section is to get the students to understand how foreign exchange markets work. The activities are designed to help them to understand the numbers they actually see in the paper, as well as the prices they may encounter in any dealings they may have with the banks. While there is more analysis in this section, by dividing it up into steps and interspersing activities, they should be able to see what is involved. However, the second part which deals with arbitrage and cross rates could possibly be left to the more enterprising.

In the first activity, the prices referred to are given at the bottom of the foreign exchange quotations in the *Report on Business*. The value for the Canadian dollar is usually also reported on the first page of this section. The idea is to confirm that the prices are indeed reciprocals, and it is important that they both be closing prices so that the are for the same moment in time. The change from the day before is also given, and the important point is that if the value of the Canadian dollar has gone up, the value of the American dollar will have gone down, and vice versa. This is the point of the second part of the question. However, students may wish to try to explain *why* the changes have taken place, and there might be reasons given in some other part of the *Report on Business*, particularly if the change is significant.

The second question is to try to help students make sense of prices for foreign exchange quoted at the banks. If the prices are for the day after the ones quoted in the paper they should reflect this and be comparable, with some margin for the banks. The prices quoted by the different banks should be comparable, but there could be small differences. You should get a better price if you are buying or selling large amount (say in excess of $10,000), and the banks may be prepared to quote rates for these larger amounts. There will of course be a spread between the buying and selling price which reflects the bank's return for providing the service.

In the first question of the second activity the focus is on the price of other currencies, and in particular the British pound sterling. The rate quoted in Canada should be the same as the cross rate obtained by multiplying the Canadian price of the U.S. dollar X the U.S. dollar price of the lb.

In the second question, if the U.S. dollar costs $1.25 in Canada, this means that the Canadian dollar should be worth 80¢ in New York. If it were quoted at 81¢ it would be overpriced, and traders would buy it in Canada for 80¢ and sell it in New York for 81¢, making $10,000 U.S. for every $1 million Canadian.

In the third activity, the idea is to analyze how changes in supply and demand affect the foreign exchange markets.

(a) Decreased exports would be shown by a decrease in the supply of $U.S., or a shift of the supply curve to the left, and the price of the U.S. dollar would increase.

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(b) Increased travel would be an increased import of services and an increase in the demand for $U.S. which would shift the demand curve to the right and increase the price of the U.S. dollar.

(c) Increased borrowing in New York would be an increased capital inflow, an increase in the supply of $U.S. and a shift of the supply curve to the right which would lower the price of the U.S. dollar.

(d) Reduced investment would be a reduced capital outflow and a reduced demand for U.S. dollars which would shift the demand curve to the left and lower the price of the U.S. dollar.

(e) Higher inflation in Canada would make our exports less competitive *and* U.S. imports more competitive. Reduced exports would shift the supply curve to the left (as in (a)), and increased imports would shift the demand curve to the right (as in (b)). Both of these changes would tend to raise the price of the U.S. dollar. This illustrates what is meant by "pricing ourselves out of world markets".

In question # 2 of the final activity, the students are asked to interpret the same changes in terms of the market for the Canadian dollar in New York.

(a) decreased exports reduce the demand for the Canadian dollar and lower its price.

(b) increased imports increase the supply of the Canadian dollar and lower its price.

(c) increased capital inflows increase the demand for the Canadian dollar and raise its price.

(d) reduced capital outflows reduce the supply of Canadian dollars and raise its price.

(e) reduced exports reduce demand, and increased imports increase supply, both of which will depress the value of the Canadian dollar.

The results in terms of price are exactly the opposite of those obtained in question # 1, as indeed they should be.

The third part of the activity illustrates intervention by the Bank of Canada. In the first case of a rising price for the American dollar, or a falling price for the Canadian dollar, the intervention would be exactly as shown in the diagram in the text. This could apply to parts (a), (b), or (e). The Bank might wish to do this to keep the price of imports from rising in order to cut down on inflation. In the second case, the Bank would have to buy up U.S. dollars equal to the excess supply in order to keep the price of the U.S. dollar from falling, or what is the same thing, the price of the Canadian dollar from rising. Supply exceeds demand at the original price in parts (c) and (d). The Bank might wish to do this to keep Canadian exports competitive in world markets, since a higher price for the Canadian dollar would tend to make them more expensive, if their prices were quoted in Canadian dollars.

In the first activity the idea is to underline the distinction between direct investment and portfolio investment, since most of this section revolves around this distinction.

(a) direct investment.

(b) portfolio investment.

(c) portfolio investment.

(d) direct investment. Pioneer was originally a subsidiary of Outboard Marine Corporation of the United States, but when Outboard planned to close it down, a rescue operation was organized by the employees and they took it over with assistance from the government. This group later sold to Electrolux of Sweden, and this transaction would represent an increase in direct foreign investment.

(e) direct investment. The repurchase of operatings in Canada controlled from abroad represents a decrease in direct investment, or negative direct investment.

The editorial cartoon from the Globe and Mail may be a bit dated for students to identify the characters, but the parallels with today are very close.

In the second activity, the costs and benefits can be taken directly from the text, and students may wish to add to these. The question of whether the costs outweigh the benefits or vice versa is one of the most hotly-debated topics in Canadian economic policy, and it is unclear that there is any generally accepted verdict, even within the economic profession. This is in contrast to the general unanimity of opinion on the benefits from trade. It is obvious that one cannot just add up the costs and the benefits and see which list is longer, but how these considerations are to be weighted is ultimately a value judgment.

Interest rates in Canada are usually higher than in the United States, and this is also true for short term rates. The other money market rates refer to a variety of financial instruments in Canada, the United States and the Eurodollar market, and students should be able to see the pattern without knowing the details of the various financial instruments involved. The money market is simply the short term end of the bond market, where large sums of money are lent and borrowed for periods up to a year and as short as overnight.

In the diagram for the Canadian dollar, if interest rates in Canada fall relative to those in the United States, capital would not be as likely to come to Canada so that the demand for the Canadian dollar would fall. At the same time more capital would tend to flow out of Canada since rates elsewhere are now relatively higher, and this would increase the supply of the Canadian dollar. Both of these changes (the demand curve shifting to the left and the supply curve shifting to the right) would tend to depress the value of the Canadian dollar. The Bank of Canada often argues that it must keep short term interest rates up to avoid this scenario.

The Canadian Exchange Rate

The opening section tries to show that the level of the exchange rate will affect the balance on current account. A depreciation of the Canadian dollar will improve the Canadian balance of payments on current account, although the effect may be delayed. Also it is pointed out that a deficit on current account is not necessarily a bad thing, and that whether it should be offset by a capital inflow or reduced through a relative decline in the value of the currency will depend upon the circumstances.

In the first Activity, the students might suggest some important Canadian exports, and many of them will likely be primary products the prices of which are usually quoted in U.S. dollars. Examples would be lumber, newsprint, copper, gas, etc. Since a depreciation of the Canadian dollar does not affect these prices, we would not expect sales to change simply because the Canadian dollar declines in value. However, sales would be more profitable, and that is why the shares of companies engaged in these businesses usually go up in value when the Canadian dollar goes down — for example, the newsprint companies like Abitibi-Price, Domtar, etc. If prices are quoted in Canadian dollars, such as with telecommunications equipment, these prices will be lower for buyers in other countries if the Canadian dollar depreciates, and so we would expect sales to increase. This may or may not mean that total proceeds increase, since total proceeds are the product of price times quantity. For example, if a product sells for $10 Canadian or $8 U.S. when $1 C = 80¢ U.S., and Canada exports 100 of them, total proceeds in U.S. dollars would be $800 U.S. If the Canadian dollar fell to 75¢ U.S., the price of the product falls to $7.50 U.S. and sales might increase to 105 units, in which case total proceeds in U.S. dollars would be $787.50 U.S. Although sales have increased, total proceeds in U.S. money have decreased, (although total proceeds in Canadian money will have increased from $10,000 to $10,500). If it is U.S. dollars that we are short of, the depreciation in the Canadian dollar might not increase the supply of them.

Canada imports a wide range of products, but most of them are prices in U.S. dollars, so that a decline in the value of the Canadian dollar increases their price to Canadians. Examples would be oil, lettuce, coffee and machinery. We would expect higher prices to cause a decline in sales, although it might take a while for some goods for which it is difficult to find substitutes in the short run — for example oil. Consequently, if we buy fewer goods we should be demanding fewer U.S. dollars, so even if proceeds from exports in terms of U.S. dollars do not increase, we should be better off after allowing for the decrease in imports. Over time we might also substitute Canadian production. This might be the case with machinery, we are trying to find more oil, we even grow more fresh lettuce year round, but we have not managed to produce coffee yet.

Trade in services is affected in much the same way. Our exports would be cheaper in terms of foreign currency, and our imports more expensive in terms of domestic currency. Travel to other countries would be more expensive for Canadians. Travel to Canada would be cheaper for foreigners. Interest payments on past borrowing in foreign currency would

be more expensive for Canadians, and as they have to be met this can be, and has been, a problem for provinces and municipalities that have borrowed abroad.

The final question simply reverses the logic of a depreciation. If the Canadian dollar appreciates in value relative to the U.S. dollar our exports become more expensive in terms of foreign currency (if priced in terms of Canadian dollars), and imports become cheaper in terms of Canadian dollars.

The second section reviews the history of the Canadian exchange rate up to 1970, and illustrates these movements with a chart.

The second Activity discusses the so-called foreign exchange crisis of 1962. The analysis earlier talked of capital inflows or currency depreciation as alternative responses to a current account deficit, but the measures taken by the government in the austerity programme in 1962 show other measures that can affect the current account balance. The higher interest rates would attract capital to Canada which would strengthen the balance of payments on capital account. They would also depress activity in Canada, and if this results in fewer imports it would strengthen the balance of payments on current account. Similarly, reduced government spending would cut back on activity in Canada and reduce demand for imports. It might also free resources to be used for producing more exports. Extra tariffs (called tariff surcharges) would reduce the demand for imports and strengthen the balance of payments on current account. Borrowing abroad would increase the foreign exchange reserves so that the government could meet the excess demand for U.S. dollars in the short run, and in this way finance the deficit. The fact that the government had no trouble maintaining the 92.5¢ rate after the panic subsided — indeed, the problem was usually keeping it from rising — indicates that the exchange rate was viable.

Whether we needed to return to a fixed rate at all is another question. It limits our freedom to some extent, particularly with respect to monetary policy. There is something circular about arguing that we should return to a fixed rate so that we can borrow money from the IMF in order to defend that rate. If we don't worry about the rate, we do not have to borrow to defend it. However, by the time confidence in the Canadian dollar was shattered in 1962, this may have been necessary to restore confidence.

The problem really arose because the government was manipulating the exchange rate rather than letting the market determine it as it had in the 1950s. People were now trying to guess what the government was up to. Moreover, the high value for the Canadian policy, as noted in the text. It was not the flexible rate that failed so much as government policies.

The final section brings the history of the value of the Canadian dollar up to the end of 1982, and discusses the debate between those who favour maintaining a value in excess of 80¢ by keeping up interest rates, and those who favour lower interest rate and letting the value of the Canadian dollar fall if necessary. The latter topic had wide coverage in the press at various times in 1982.

In the third Activity, students are asked to think about the arguments given on both sides concerning what the value of the Canadian dollar should be. Many of these points are mentioned in the text, but other points might be raised, such as how far would the value of the Canadian dollar fall if we had a "made-in-Canada" interest rate policy. Would a falling Canadian dollar improve the balance on current account, and how quickly would this happen? Would a falling Canadian dollar cause a flight of capital out of Canada? What should the level of interest rates be in Canada anyway? Since we have a lower income in Canada than in the United States, would we not expect lower savings and a higher rate of interest given large opportunities for investment? And if we have higher inflation in Canada, do we not need a higher rate of interest in order that lenders are as well off, after inflation, as they would be in the U.S.?

The critics of the Bank of Canada come from a variety of areas. They include people like Walter Gordon (the former Liberal Finance Minister mentioned in the cartoon in the preceding section) and others in the Canadian Institute for Economic Policy associated with economic nationalism; some NDP spokesmen; some labour leaders; economists who argue that the Bank of Canada should not direct its policy toward maintaining a particular value for the exchange rate, but should direct it towards what is correct for Canada — for example, Tom Courchene.

It is appropriate to also look at times when the Canadian dollar has had a high value. It is interesting that in both the 1970s and the late 1950s high values for the Canadian dollar were associated with interest rates that were criticized as being inappropriately high. Whether the argument holds today returns us to the opening question.

The fourth question is one for the futurists, and one guess is as good as another. In the short run it certainly seems unlikely that the Canadian dollar will return to equality with the U.S. dollar.

The Canadian dollar rose in value relative to currencies other than the U.S. dollar in 1982, because the U.S. dollar rose faster in relation to those currencies than it did in relation to the Canadian dollar, and the value of those currencies in terms of Canadian dollars is the product of the cost of the U.S. dollar x the U.S. dollar cost of those currencies. This was mainly because high interest rates in the U.S. attracted a capital inflow to the U.S. which pushed up the value of the U.S. dollar. Canadians who travelled to Europe in 1982 found that their Canadian dollars went further than the year before.

The International Monetary System

The insert on "Canada in the Bretton Woods System" gives a few of the facts concerning Canadian involvement in the IMF and World Bank. It might give rise to a discussion of whether or not this has been a good thing for Canada, whether it should give more or less support, etc.

In the Activity at the end the questions attempt to relate to some of the very current problems in the international monetary sphere.

In the first question, students might suggest Mexico, Brazil, Argentina, Poland or perhaps some place as exotic as Zaire. The first three mentioned are the biggest concern, because they together owe such a large proportion of third world debt, which is estimated at the end of 1982 to be about $626 billion. Mexican and Brazilian debt is estimated to be at least 80 billion each. However, a drop in the price of oil would affect these two countries very differently, since Mexico is an oil exporter (although not a member of OPEC) and Brazil is an oil importer. Obviously Mexico's problems get worse if the oil price falls, and indeed many of her present troubles stem from the fact that lenders saw a rosy future for Mexico as the price of oil continued to climb and lent on the basis of that promise which was not fulfilled.

The question of whether Canada should give aid multilaterally or bilaterally is a hotly debated issue. Bilateral aid gives Canada more control and is usually tied to purchases of Canadian goods. While this ensures that Canada will get some exports for its money, it means that the aid is not as valuable to developing countries since they may not be able to buy the goods they want and at the cheapest prices. Some estimates say that tying aid reduces its value by 20%. It obviously would be easier for developing countries to deal with one agency for aid than to deal with a lot of donor countries individually, and it can be argued that the one central agency has a much better idea of what is really needed and what works best than can individual agencies in each of the donor countries. The International Development Agency is thought by many in the development field to be the most efficient use of aid money.

The third question tries to point out the impossibility of expecting the developing countries to pay back debts if they cannot earn the money to do so. If they cannot pay back their debt many private banks in the world would be in serious difficulties, and this would include several of the large Canadian banks. On the other hand imports of labour intensive goods from developing countries threaten jobs in the industrialized countries, and governments have been restricting them by quotas and other devices. It is not surprising to hear the chairman of a major Canadian bank saying we have to allow more imports from developing countries and adjust our economy so that we can export goods to them.

The final question deals with Canada's foreign exchange reserves and its current policy of selling off gold. The role of gold in the international monetary system is unclear. It has no official status any more and no official price. However, most countries hold gold in their reserves, and for some countries it is the major reserve — for example, France. Countries borrow against the collateral of their gold reserves. Obviously Canada is getting more for the gold then it is valued at in the reserves, but this valuation is merely a matter of convention, and she could choose any method of valuation she wanted. The funds received can be invested at interest, whereas the gold bears no interest and has to be safeguarded. Ultimately the wisdom probably depends upon what the price of gold will be in the future, and that value is anybody's guess.